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## Introduction

Congratulations on your great decisions to buy “Sure -Fire Forex Trading”. It is my hope that you find true value in this ebook and learn something new about how to trade the forex market.

Broadly speaking the book is divided into five main parts.

### 1. Introduction to the forex market

Everyone should read this section of the book. It doesn't matter if you think you know how the forex market works; you need this background to better understand all the components that drive the market.

### 2. Beginners guide to trading.

If you are an experienced trader you may want to just skim over this part as it is mainly aimed at new traders. Many people who read this book will be learning to trade for the first time. For experienced traders it may seem boring to go over the basics, but believe me experience has taught me never to assume how much other traders know.

### 3. Components of the trading method.

It is vital that everyone understands what makes up the main parts of the trading method. It is not merely enough to just jump straight into the method itself without understanding how the parts of the method all play a part.

### 4. The trading method.

As you have probably guessed, this is the most important part of the book. Here I will go into the method in as much detail as possible. You may need to go through this section a few times to really understand what is going on.

### 5. Advanced Trading Method

This is where we take a look at a more advanced method of trading.

### 6. Key points in trading.

Again everyone should read this part of the book as the method alone will not make you a good trader. There are many parts to trading and in this section I hope to tie it all together.

## Introduction To The Forex Market

The foreign exchange market is perhaps the most interesting of all markets, as it is one of the few markets where the sheer size of the market makes it almost impossible for any one person, institution or government to control.

Forex has come of age and is now one of the most exciting markets for traders to become involved in. Even though I have traded many markets I have always had a soft spot for forex. Perhaps it is because it was the first market that I learned to trade or it might be that it just seems so familiar to me. Whenever I look at a FX chart, it's like an old friend that just keeps getting bigger and bigger.

The word FOREX is derived from **Foreign Exchange** and is the largest financial market in the world. Unlike many markets the FX market is open 24 hours per day and has an estimated \$1.2 Trillion in turnover every day.

This tremendous turnover is more than the combined turnover of the New York and London Stock Exchange on any given day. This tends to lead to a very liquid market and is therefore a desirable market to trade.

The foreign exchange market allows customers, fund managers and banks to buy and sell foreign exchange on a global basis. The trade of goods, services, loans and speculation leads to a very active market.

With the introduction of the mini account, deals can be anything from a few thousand dollars to billions of dollars.

The thing about the forex market is that transactions need to happen. When I say that they need to happen - I mean that large institutions and governments need to conduct and exchange currencies on a global scale. They have virtually no choice. Companies raising money in the stock market also have no choice, but an investor does not need to buy a stock. A government has no choice when it comes to forex.

Forex has no centralized market, unlike many other securities. There is no single centralized place for the trade of forex. Traders buy and sell forex via telephones and computers linked to brokers, bank and other traders around the world.

You will often hear the term INTERBANK discussed in forex terminology. This originally, as the name implies, was simply, banks and large institutions exchanging information about the current rate of exchange at which their clients or themselves were prepared to buy or sell a currency.

**INTER** meaning between and **Bank** meaning deposit-taking institutions - normally made up of banks, large institution, brokers or even the government.

The market has moved on to such a degree now that the term interbank now means anybody who is prepared to buy or sell a currency.

It could be two individuals or your local travel agent offering to exchange Euros for US Dollars. You will however find that most of the brokers and banks use centralized feeds to insure reliability of quote.

The quotes for Bid (buy) and Offer (sell) you see will most always be from the larger players in the market. London in the United Kingdom is the single largest center for the exchange of forex.

The main reasons that London has a higher percentage of trade is that it has always been a financial center and also because of time zones.

The London market starts between 7am and 8am, which is the end of the trading day for Asia. Just as the Banks in London are beginning to open at 8am

| <u>Average Daily Foreign Exchange</u><br>Market Turnover In The Main Centres |               |
|--|---------------|
| April 1998   | US\$ Billions |
| United Kingdom   | 637           |
| United States  | 351           |
| Japan  | 149           |
| Singapore  | 139           |
| Germany  | 94            |
| Switzerland  | 82            |
| Hong Kong  | 79            |
| France   | 72            |

Source: Bank Of International Settlements

they can deal with other traders in Tokyo, Hong Kong or Singapore whose trading day is just coming to a close.

During the later part of the trading day in London, the U.S.A market opens up and so catches a healthy portion of that market as well.

Here is an interesting fact for you. Up until the 1930's the British Pound used to be traded via telex machines run through cables, which led to the Pound being nicknamed "cable". You can still often here the Pound called cable.

Also, until the Second World War the British Pound was the main reserve for most other countries. After the Second World War Britain's economy was in tatters and the U.S. Dollar became the reserve of most countries.

This largely came about as a result of the 1944 Bretton Woods conference in New Hampshire, which established the foundation of the postwar global economy and the birth of the World Bank along with the International Monetary Fund.

## **The Players**

There are three main types of players in the forex market: customers, banks and brokers.

### **Customers**

Customers can further be divided into individuals, small business and larger corporate type businesses.

Corporate Businesses often need to make cross boarder transactions in order to trade their goods or services.

Many companies have to import or exports goods to different countries all around the world. Payment for these goods and services may be made and received in different currencies.



Many billions of dollars are exchanged daily to facilitate trade. The timing of those transactions can dramatically affect a company's balance sheet.

Although you may not think it, all of us play a part in today's FX world. Every time someone goes on holiday overseas he or she normally needs to purchase that country's currency and again change it back into his/her own currency once he/she returns. Unwittingly he or she is in fact trading forex.

He or she may also purchase goods and services whilst overseas and their credit card company has to convert those sales back into his base currency in order to charge him.

If you think of just how many tourists are traveling at any given time, then you can imagine just how much this can add up.

## **Banks**

Under the heading bank we could also include the larger of the funds who are also deposit taking institutions. As a forex speculator you are actually taking the place of a bank for the duration of a trade, if you think about you are holding large amounts of foreign exchange just as a bank would.

Policies that are implemented by governments and central banks can play a major roll in the FX market. Central banks can play an important part in controlling the country's money supply to insure financial stability.

Large banks can literally trade billions of dollars daily. This can take the form of a service to their customers, trades executed on behalf of large clients or they themselves can speculate on the FX market.

Because of the size of some transactions banks may be unable to deal directly with other banks and will state the price they are prepared to accept for a currency or pay for a currency. This is called market making.

They will quote the buying or selling rates they are prepared to pay for pairs of currencies e.g. the Dollar to Japanese Yen or Pound to Dollar.

The market maker (in this case the bank) makes its profit from the difference between the buying and selling rate (spread).

## Hedge Funds

As we know the FX market can be extremely liquid, which is why it can be desirable to trade. Hedge Funds have increasingly allocated portions of their portfolios to speculate on the FX market.

Another advantage for Hedge Funds is that they can utilize a much higher degree of leverage than would typically be found in the equity markets.

## Brokers

The broker's main function is to facilitate trade between two parties.

They normally have links to other brokers, banks and institutions and often become mini market makers themselves.

Because of the varied source of clients who use brokers it is quite common to find the best rates through a broker as opposed to a bank.

With a broker you can shop for the best rates in order to transact your business.

The broker makes his commission from either the difference between the buying and selling rate or as a flat fee per transaction

All of the three main groups will also speculate in the market, which is why the market has so much volume and liquidity.

## Different Section Of The Forex market

### **The Spot Market**

The spot or cash market is the actual price of a currency at that moment in time - the price for immediate delivery. A trader will contact his broker or bank and ask for a price for the pair of currencies he wants to trade.

A spot contract is a contract between two parties who exchange an agreed upon amount of two currencies at an agreed upon exchange rate.

The normal delivery time for a forex contract is two days. With the exception of the Canadian dollar which is one day. The reason for the two days for deliver was established long before modern technology and sufficient time was needed to verify all the details of the transaction. Nowadays, transactions are concluded in fractions of a second.

Transactions are normally concluded via telephone or automated dealing desks. When using the telephone to transact a trade it is important to know the correct etiquette. This can differ dramatically from broker to broker or bank to bank. It is important that you first contact your broker or bank and ask for the correct procedure for placing orders.

The spot market is the market this book is concentrated on and is the market most traders will speculate on. I will however cover other common vehicles of trading forex for reference.

## Forwards

Forward trading is different from spot trading in that you must take into account the interest differential.

As each country has its own interest rate, the difference in the interest rate must be taken into consideration. If the interest rate in one country is 5% and the interest rate in another country is 3% then the interest differential is 2%.

Forwards Outright deals are deal in which two parties agree the price of the two currencies involved at a forward (future) date, normally 3 days to 3 years, although the majority of contracts are for under six months.

Because no one really knows what the exchange rate for two currencies will be in the future, a forward attempts to calculate what a fair value for the two currencies will be by taking into account the interest rate of each country.

Forward rates are normally higher or lower (at a premium or at a discount) to the spot rate.

$$\frac{\text{Spot rate X (interest differential, e.g. Dollar interest rate – Euro interest rate) X days/360}}{1 + (\text{Euro interest rate X days/360})}$$

Premiums and discounts show the interest differential between two currencies at the time of the deal.

The determination of a forward price is not a prediction of the future exchange rate. It is merely a tool to allow interested parties to fix a rate in the future.

## Swaps

A swap is simply a combination of a spot deal whilst at the same time making a forward deal or vice versa.

Let's say that the "Really Big Company" wants to do a deal in Europe but the bean counters believe they can get a better deal in the U.S. because they have good relationship with some financial institutions there.

So the "Really Big Company" borrows \$5 million at 4% over the next 5 years in the U.S.

At the same time the "Really Big Company" makes a deal to trade its future dollar liability for Euros.

Under the terms of the deal the bank/broker agrees to pay the "Really Big Company" enough dollars to service its dollar loan and in return the "Really Big Company" agrees to make a series of annual payment to the bank/broker in Euros. This is a currency swap.

## Currency Futures

Currency futures are a particular type of forward transaction. They have specific contract sizes, maturity dates and are traded on a formal exchange e.g. The Chicago Mercantile Exchange.

They are less flexible than a forward contract inasmuch as they have specific delivery dates. Trading in currency future also may have additional costs such as trading through a member of an exchange.

The advantage of the currency futures contract is that smaller players can get involved, as there is a smaller initial capital outlay relative to the contract size.

Also forward contracts can be very slow to move. There is much more volatility in the futures market, which as a trader we need. It's also much easier to find information on currency futures through any good data supplier.

## Currency Options

Currency option provide the buyer with the right but not the obligation, to sell or buy an amount of forex at an exchange rate and date specified in advance.

The buyer must pay a premium to the writer of the option, which in most cases will be the broker or bank.

The main advantage of the option is that the user of the option can guarantee the buying price (call) or selling price (put) of the currencies he is interested in without giving up the advantage of potential favorable currency movements. This is because he can still take advantage of the spot market if he so wishes.

## Intervention

When the central bank of a country intervenes in its currency it normally does so in one of two ways. Either unsterilized (naked) or sterilized intervention.

Unsterilized intervention is when a country buys or sells its own currency to try and influence the exchange rate. This will effect its money supply and thus effect interest rates and prices. This can effect many areas of an economy and has long lasting effects on the economy.

Sterilized intervention is when the central bank intervenes in its currency but does so by selling government securities to back up its intervention. This is the most popular method of intervention and tends to only effect the supply and demand of the currency.

Some countries are more prone to intervention than others. This may because of economic or political factors - a good example is the Japanese Yen.

## Currency Designations

As I mentioned earlier currencies are traded in pairs, and are each assigned a symbol.

For the Japanese Yen it is JPY, for the Pound Sterling it is GBP, for Euro it is EUR and for the Swiss Franc it is CHF. So, EUR/USD would be Euro-Dollar pair. GBP/USD would be Pounds Sterling-Dollar pair and USD/CHF would be Dollar-Swiss Franc pair and so on.

You will always see the USD quoted first with few exceptions such as Pounds Sterling, Euro Dollar, Australia Dollar and New Zealand Dollar. The first currency quoted is called the base currency. Have a look below for some example.

| <b>Currency Symbol</b> | <b>Currency Pair</b>           |
|------------------------|--------------------------------|
| EUR/USD                | Euro / US Dollar               |
| GBP/USD                | Pounds Sterling/ US Dollar     |
| USD/JPY                | US Dollar / Japanese Yen       |
| USD/CHF                | US Dollar / Swiss Franc        |
| USD/CAD                | US Dollar / Canadian Dollar    |
| AUD/USD                | Australian Dollar / US Dollar  |
| NZD/USD                | New Zealand Dollar / US Dollar |

When you see FX quotes you will actually see two numbers. The first number is called the bid and the second number is called the offer (or ASK).

If we use the EUR/USD as an example you might see

0.9950/0.9955

The first number 0.9950 is the bid price and is the price traders are trying to buy Euros against the USD Dollar. This is the price you will get if you are selling.

The second number 0.9955 is the offer price and is the price traders are prepared to sell the Euro against the US Dollar and is the price you will pay if you want to buy the pair.

These quotes are sometimes abbreviated to the last two digits of the currency such as 50/55. Each broker has its own convention and some will quote the full number and others will show only the last two.

You will also notice that there is a difference between the bid and the offer price and this is called the **spread**. For the four major currencies the spread is normally 5 pips give or take a pip. Something you will also have to be aware of is **slippage** - the loss of pips between where a order (stop or limit) becomes a market order and where that market order may be filled. New traders often think that the difference between the price they see on their charts and the price the broker quotes them is slippage. This is wrong. Your charting software and broker prices are two different things.

The most common increment of a currency is the PIP. If the EUR/USD moves from 0.9550 to 0.9551 that is one pip.

A pip is the last decimal place of a quotation. The pip or POINT as it is sometimes referred to, depending on context, is how we will measure our profit or loss.

To carry on from the symbol conventions and using our previous EUR quote of 0.9950 bid, that means that 1 Euro = 0.9950 US Dollars. In another example if you used the USD/CAD 1.4500 this would mean that 1 US Dollar = 1.4500 Canadian Dollars.

As each currency has its own value, it is necessary to calculate the value of a pip for that particular currency. We also want a constant, so we will assume that we want to convert everything to US Dollars.

In currencies where the US Dollar is quoted first, the calculation would be as follows.

Example JPY rate of 116.73 (notice the JPY only goes to two decimal places, most of the other currencies have four decimal places)



In the case of the JPY 1 pip would be .01 therefore

USD/JPY: Rate 116.73

(.01 divided by exchange rate = pip value) so

$$.01/116.73=0.0000856$$

It looks like a big number but later we will discuss lot (contract) size.

USD/CHF: Rate 1.4840

(.0001 divided by exchange rate = pip value) so

$$.0001/1.4840 = 0.0000673$$

USD/CAD: Rate 1.5223

(.0001 divided by exchange rate = pip value) so

$$.0001/1.5223 = 0.0001522$$

In the case where the US Dollar is not quoted first, and we want to get to the US Dollar value we have to add one more step.

EUR/USD: Rate 0.9887

(0.0001 divided by exchange rate = pip value) so

$$.0001/0.9887 = \text{EUR } 0.0001011$$

but we want to get back to US Dollars so we add another little calculation which is EUR X Exchange rate so  $0.0001011 \times 0.9887 = 0.0000999$  when rounded up it would be 0.0001.

GBP/USD: Rate 1.5506

(0.0001 divided by exchange rate = pip value) so

$$0.0001/1.5506 = \text{GBP } 0.0000644$$

but we want to get back to US Dollars so we add another little calculation which is GBP X Exchange rate so  $0.0000644 \times 1.5506 = 0.0000998$  when rounded up it would be 0.0001.

By this time you might be rolling your eyes and thinking - do I really need to work all this out? The answer is no.

Nearly all the brokers you will deal with will work all this out for you. They may have slightly different conventions but it is all done automatically.

It is good however for you to know how they work it out. In the next section we will be discussing how these seemingly insignificant amounts can add up.

Spot Forex is traditionally traded in **contracts** also referred to as **lots**. The standard size for a contract is \$100,000.

In the last few years a mini lot size has been introduced of \$10,000 and this again may change in the years to come.

As we mentioned on the previous page currencies are measured in pips, which is the smallest increment of that currency. To take advantage of these tiny increments it is desirable to trade large amounts of a particular currency, in order to see any significant profit or loss.

I shall cover leverage later but for the time being let's assume we will be using \$100,000 lot size. We will now recalculate some examples to see how it effects the pip value.

USD/JPY at an exchange rate of 116.73

$$(.01/116.73) \times \$100,000 = \$8.56 \text{ per pip}$$

USD/CHF at an exchange rate of 1.4840

$$(0.0001/1.4840) \times \$100,000 = \$6.73 \text{ per pip}$$

In cases where the US Dollar is not quoted first the formula is slightly different.

EUR/USD at an exchange rate of 0.9887

$$(0.0001/0.9887) \times \text{EUR } 100,000 = \text{EUR } 10.11 \text{ to get back to US Dollars we add a further step}$$

$$\text{EUR } 10.11 \times \text{Exchange rate which looks like } \text{EUR } 10.11 \times 0.9887 = \$9.9957 \text{ rounded up will be } \$10 \text{ per pip.}$$

GBP/USD at an exchange rate of 1.5506

$(0.0001/1.5506) \times \text{GBP } 100,000 = \text{GBP } 6.44$  to get back to US Dollars we add a further step

$\text{GBP } 6.44 \times \text{Exchange rate which looks like } \text{GBP } 6.44 \times 1.5506 = \$9.9858864$  rounded up will be \$10 per pip.

As we said earlier your broker may have a different convention for calculating pip value relative to lot size but, whatever way they do it, they will be able to tell you what the pip value for the currency you are trading is, at that particular time.

Remember that as the market moves so will the pip value depending on what currency you trade.

So now we know how to calculate pip value lets have a look at how you work out your profit or loss.

Let's assume you want to buy US Dollars and Sell Japanese Yen. The rate you are quoted is 116.70/116.75 because you are buying the US you will be working on the 116.75, the rate at which traders are prepared to sell. So you buy 1 lot of \$100,000 at 116.75.

A few hours later the price moves to 116.95 and you decide to close your trade. You ask for a new quote and are quoted 116.95/117.00 - as you are now closing your trade and you initially bought to enter the trade, you now sell in order to close the trade and you take 116.95 the price traders are prepared to buy at.

The difference between 116.75 and 116.95 is .20 or 20 pips. Using our formula from before, we now have  $(.01/116.95) \times \$100,000 = \$8.55$  per pip  $\times 20$  pips = \$171

In the case of the EUR/USD you decide to sell the EUR and are quoted 0.9885/0.9890 you take 0.9885.

Now don't get confused here. Remember you are now selling and you need a buyer. The buyer is bidding 0.9885 and that is what you take.

A few hours later the EUR moves to 0.9805 and you ask for a quote. You are quoted 0.9805/0.9810 and you take 0.9810.

You originally sold EUR to open the trade and now to close the trade you must buy back your position. In order to buy back your position you take the price traders are prepared to sell at which is 0.9810.

The difference between 0.9810 and 0.9885 is 0.0075 or 75 pips. Using the formula from before, we now have  $(.0001/0.9810) \times \text{EUR } 100,000 = \text{EUR } 10.19$ :  $\text{EUR } 10.19 \times \text{Exchange rate } 0.9810 = \$9.99(\$10)$  so  $75 \times \$10 = \$750$ .

To summarize, when you enter or exit a trade, at some point you are subject to the spread in the bid/offer quote.

As a rule of thumb when you buy a currency you will use the offer price and when you sell you will use the bid price. So when you buy a currency you pay the spread as you enter the trade but not as you exit and when you sell a currency you pay no spread when you enter but only when you exit.

## Crosses

A cross currency transaction is when two currencies that do not involve the U.S. Dollar are involved, such as EUR/JPY. Commonly referred to as a cross.

## Exotics

An exotic transaction is the exchange of currencies that are not commonly traded. This might be because the country is not as industrialized as the rest of the developed world or because there is little interest in trading the pair because there is little or no volume. An example of this might be the Nigerian Naira.

## Major Currencies Traded

As you can see from the table below, over 90% of all currencies are traded against the US Dollar. Simply put – over 90% of all trades had the U.S. Dollar on one side of the trade. The four most traded currencies after the USD are the Euro (EUR), Japanese Yen (JPY), Pound Sterling (GBP) and Swiss Franc (CHF).

| Source: Bank For International Settlements <a href="http://www.bis.org">http://www.bis.org</a> |      |      |      |      |      |
|--|------|------|------|------|------|
| Currency   | 1989 | 1992 | 1995 | 1998 | 2001 |
| US Dollar  | 90   | 82.0 | 83.3 | 87.3 | 90.4 |
| Euro   |      |      |      |      | 37.6 |
| Japanese Yen   | 27   | 23.4 | 24.1 | 20.2 | 22.7 |
| Pound Sterling   | 15   | 13.6 | 9.4  | 11.0 | 13.2 |
| Swiss Franc  | 10   | 8.4  | 7.3  | 7.1  | 6.1  |

As currencies are traded in pairs and exchanged one for the other when traded, the rate at which they are exchanged is called the **exchange rate**. These four currencies traded against the US Dollar make up the majority of the market and are called major currencies or the majors.

The Australian Dollar and Canadian Dollar are also popular to trade but I will be concentrating on the majors. The AUD/USD and USD/CAD are known as the minors

From here on in we shall refer to the currencies by their designation. So remember to check the table on designation of currencies.

## Leverage

Leverage, financed with credit, such as that purchased on a margin account is very common in Forex.

A margined account is a leverageable account in which Forex can be purchased for a combination of cash or collateral depending what your brokers will accept.

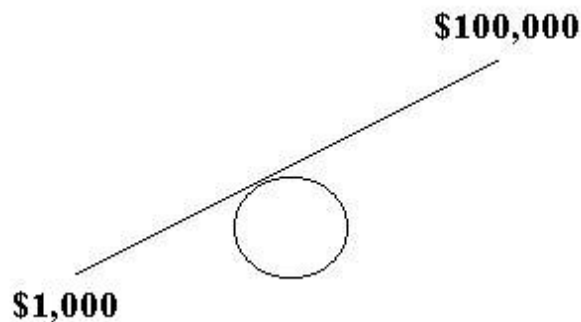
The loan (leverage) in the margined account is collateralized by your initial margin (deposit). If the value of the trade (position) drops sufficiently, the broker will ask you to either put in more cash, or sell a portion of your position or even close your position.

Margin rules may be regulated in some countries, but margin requirements and interest vary among broker/dealers, so always check with the company you are dealing with to ensure you understand their policy.

Up until this point you are probably wondering how a small investor can trade such large amounts of money (positions).

The amount of leverage you use will depend on your broker and what you feel comfortable with.

There was a time when it was difficult to find companies prepared to offer margined accounts at all, but nowadays you can get leverage from as high as 1% with some brokerages. This means you could control \$100,000 with only \$1000.



Typically the broker will have a minimum account size also known as account margin or initial margin e.g. \$10,000.

Once you have deposited your money you will then be able to trade. The broker will also stipulate how much they require per position (lot) traded. In the example above for every \$1,000 you have you can take a lot (contract) of \$100,000. So if you have \$5,000 they may allow you to trade up to \$500,000 of forex.

That's the theory, but in practice you need to have tradeable equity in your account.

The minimum security (Margin) for each lot will vary from broker to broker. In the example above the broker required a 1.0% margin.

This means that for every \$100,000 traded the broker wanted \$1,000 as security on the position.

Variation Margin is also very important. Variation margin is the amount of profit or loss your account is showing on open positions.

Let's say you have just deposited \$10,000 with your broker. You take 5 lots of USD/JPY which is \$500,000. To secure this the broker needs \$5,000 (1.0%).

The trade goes bad and your losses equal \$5,001, your broker may do a margin call.

The reason he may do a margin call, is that even though you still have \$4,999 in your account - the broker needs that as security and allowing you to use it could endanger yourself and him.

Another way to look at it is this, if you have an account of \$10,000 and you have a 1 lot (\$100,000) position. That's \$1,000 assuming a (1% margin) is no longer available for you to trade.

The money still belongs to you, but for the time you are margined, the broker needs that as security.

Another point of note is that some brokers may require a higher margin at the weekends and overnight. This may take the form of 1% margin during the normal trading day and 2% margin overnight and 4% over the weekend.

Also in the example we have used a 1% margin. This is by no means standard. I have seen as high as 0.5% and many between 3%-5% margin. It all depends on your broker.

There have been many discussions on the topic of margin and some argue that too much margin is dangerous. This is a point for the individual concerned.

The important thing to remember, as with all trading, is that you thoroughly understand your brokers policies on the subject and you are comfortable with and understand your risk.

## Margin Call

Margin call is something that you will have to be aware of. If for any reason the broker thinks that your position is in danger e.g. you have a position of \$100,000 with a margin of one percent (\$1,000) and your losses are approaching your margin (\$1,000). He will call you and either ask you to deposit more money, or close your position to limit your risk and his risk.

Margin call is actually a good thing. It safeguards you and your broker. Some traders become so emotionally involved with their position that they are incapable of making a rational decision. If a margin call is exercised it will safeguard the trader from further losses.

If you are going to trade on a margin account, it is imperative that you talk with your broker first to find out what their policies are on this type of accounts.

## Rollovers

In Spot FX the majority of the time the end of the business day is 21h59 (London time).

Any positions still open at this time are automatically rolled over to the next business day, which again finishes at 21h59.

This is necessary to avoid the actual delivery of the currency. As Spot FX is predominantly speculative, most of the time the trader never wishes to actually take delivery of the currency.



They will instruct the brokerage to always rollover their position. Many of the brokers nowadays do this automatically and it will be in their policies and procedures.

The act of rolling the currency pair over is known as tom.next which, stands for tomorrow and the next day. Just to go over this again, your broker, will automatically rollover your position unless you instruct him that you actually want delivery of the currency.

Another point worth noting is that most leveraged accounts are unable to actually take delivery of the currency, as there is insufficient capital there to cover the transaction.

Remember that if you are trading on margin, you have in effect got a loan from your broker for the amount you are trading. If you had a 1 contract position, your broker has advanced you the \$100,000 even though you did not actually take delivery of the \$100,000.

The broker will normally charge you the interest differential between the two currencies if you rollover your position. This normally only happens if you have rolled over the position and not if you open and close the position within the same business day.

To calculate the interest, the broker will normally close your position at the end of the business day and again reopen a new position almost simultaneously.

For example, you open a 1 contract (\$100,000) EUR/USD position on Monday 15th at 11h00, at an exchange rate of 0.9950.

During the day the rate fluctuates and at 22h00 the rate is 0.9975. The broker closes your position and reopens a new position with a different value date.

The new position was opened at 0.9976 a -1 pip difference. The 1 pip difference reflects the difference in interest rates between the USD and the EUR.

In our example, you are long EUR and short USD. As the USD in the example has a higher interest rate than the EUR, you pay the premium of 1 pip.

Now the good news. If you had the reverse position, and you were short EUR and long USD, you would gain the interest differential of 1 pip.

If the first named currency has an overnight interest rate lower than the second currency, you will pay that interest differential if you bought that currency.

If the first named currency has a higher interest rate than the second currency, you will gain the interest differential.

To simplify the above. If you are long (bought) a particular currency and that currency has a higher overnight interest rate you will gain. If you are short (sold) the currency with a higher overnight interest rate then you will lose the difference.

I would like to emphasize here that although I am going a little in-depth to explain how all this works, your broker will calculate all this for you. The purpose of this book is just to give you an overview of how the forex market works.

### **Which Currency Is Your Profit/Loss IN?**

Although the movement today is towards all transaction eventually finishing in a profit or loss in USD, it is important to realize that your profit or loss may not actually be in USD.

As you would expect this is most obvious in the US. Most US based traders assume they will see their balance at the end of each day in USD. I have even spoken with some traders who are oblivious to the fact the their profit might have actually been in Japanese Yen.

Let me explain a little more. You buy (go long) USD/JPY and as such are long USD and short (sell) JPY. You enter the trade at 116.10 and exit 116.90. You in fact made 80,000 Japanese Yen (1 contract traded) not US Dollars.

If you traded all four major currencies against the US Dollar you would in fact have made or lose in EUR, GPY, JPY and CHF.

This might give you a ledger balance at the end of the day or month with four different currencies. This is common in London. Your profit and loss will stay in that currency you made a profit or loss in until you instruct the broker to exchange those currencies into your own base currency.

This actually happened to me. After dealing with mainly US based brokers, it had never occurred to me that my statement would be in anything other than US Dollars.

This can work for you or against you depending on the rate of exchange when you change back into your home currency. Once I knew the convention I simply instructed the broker to change my profit or loss into US Dollars when I closed my position. It is worth checking how your broker approaches this and simply ask them how they handle it. A small point but worth noting.

London has been regulated for many years and the US is now getting its act together and is now also regulated. It was only recently in the US you could, with no more than an Internet site and a few thousand dollars set up your own forex operation and give the impression that your operation was much larger than is really was. I am all for the entrepreneurial flair and everyone needs to start somewhere, but when dealing with people's money it is imperative that the company you choose is solid.

## Regulation

Preferably you want a company that is regulated in the country that it operates, insured or bonded and has some kind of track record.

I cannot advise you on which broker you should use as there are just too many variables. But as a rule of thumb, nearly all countries have some kind of regulatory authority who will be able to advise you.

Most of the regulatory authorities will give you a list of brokers that fall within their jurisdiction. Although they won't advise you who to use, you will be able to use the recommended broker with some confidence.

Once you have a list give a few of them a call, see who you feel comfortable with, then ask them to send you their policies and procedures. If you live near where your broker is based, go and spend the day with him or her. I have been to many brokerages just to check them out. This will give you a chance to see their operation and meet their team.

This brings up another interesting point. When you open an account with a broker you will have to fill in some forms, basically stating your acceptance of their policies. This can range from a 1- page document to something resembling a book.

Take the time to read through their documents and make a list of things you don't understand or want explained. Most reputable companies will be happy to spend some time with you. Your involvement with your broker is largely up to you. As a forex trader you will probably spend long hours staring at the screen without talking to anyone. This may appeal to you or you may want to chat with the dealer in the trading room. You can expect a call once a week or once a month from someone in the brokerage, asking if you are happy with the service offered and if you are experiencing any problems.

## Forex Trading 101

In this section we are going to go over the basics of trading. There will be a large percentage of people who read this book who already know this stuff but there will also be a large percentage of people who have never traded before and need to read this in order to better understand how things work. Traders new to trading need to get to grips with the basics first.

### Technical Analysis

Technical analysis is the study of market action, mainly through the use of charts and indicators to forecast the future price of a security. There are three main points that a technical analyst applies.

- A. Market action discounts everything. Regardless of what the fundamentals are saying, the price you see is the price you get.
- B. The price of a given security moves in trends.
- C. The historical trend of a security will tend to repeat itself.

Of all of the above points, the most important is point A. It is important for you to understand this point, as it is the basis of this approach to trading.

When you look at the price of any financial instrument, as a technical analyst, you believe that is the true value of the instrument, as the market sees it. Using a technical approach, you believe that all the factors that effect price, including, fundamental, political and psychological have all been built into the price you see.

All this means is that - anything that can effect the price of a security has already been allowed for by the market participants. Technical analysts look at charts the same way a doctor would look at x-rays. They examine the charts for information on the future direction of the markets.

Technical analysis is the study of human behavior represented on a chart.

## The Dow Theory

You will hear a lot about the Dow Theory as you travel through your trading career. Dow himself never actually used the phrase. That came later as analysts began to use the term.

I should back up here slightly and mention that in 1884 Dow published his first stock market average of 11 stocks. From the original 11 stocks, there were some changes and rearrangements of the average, until finally in 1928 he settled on 30 stocks which are now known as the industrial average and that is where we get the term the 'Dow Jones Industrial Average'.

The actual theory is fairly straightforward to explain and sensible if you take the time to think about it. I shall simplify it slightly, as we have not covered some of the terms yet.

1. The market discounts everything. The price you see is the true value of the market. If you are following a particular stock and it is trading at \$10 then that is a fair value of that stock. It assumes that all the known information about that stock has been taken into consideration by the market and is reflected in the price. If new information was introduced it would change the price of the stock but it would still be reflected in the price.
2. The market has three main trends. You will begin to come across some technical expressions now but just bear with me and I will explain them to you later.

Dow's interpretation of a trend was that each rally high be higher than the previous rally high and each rally low be lower than the previous rally low.

The three trends were - a primary trend, a secondary trend and minor trends. Now this is important because later on as we discuss this, it will play a major role in our analysis.

The primary trend is the main force behind the trend and is like a river flowing in a particular direction. The secondary trend is like tributary to the main trend. It may diverge for a time but eventually it will come back in line with the main river. The minor trend is like a small stream, which runs this way and that but is headed, in the general direction of the river.

The primary trend may take years to come to an end and develops over time. The secondary trend can take anywhere from a few weeks to a few months in duration and the minor trend may be in the opposite direction of the primary trend. Minor trends such as daily trend last a few days or so and are of little significance.



3. In addition to the three types of trends, Dow then went on to further qualify the trend by saying that the trend has three phases. An accumulation stage, the public participation stage and finally the distribution stage.
4. As the original Dow average was composed of shares from different sectors the next part of the Dow theory is that the average of the different sectors must confirm each other.

5. Dow also considered the effect of volume on a trend. He stated that volume should expand in the same direction of the trend.
6. The last major part of the theory is: the trend should be assumed to still be in force until there is a definite indication that the direction has in fact changed.

My interpretation of the Dow theory above is very brief as it is beyond this book to delve to deeply into any one particular subject.

It is also not necessary for what I am trying to achieve and that is to give you a broad idea of how the markets work and some ways to trade them. We will get more specific about things later.

The main point I want you to take away from the Dow theory is that there are three types of trends, a primary trend, a secondary trend and minor trends. We can use this in our approach.

## **Terminology's**

During the course of your trading career you will be using terms and expression that you may be unfamiliar with. It is important that you understand the basic terminology's used before you start trading.

## **BULL MARKET**

When the BUYING market is more predominate than the SELLING market here are some expressions commonly used:

BUYING  
BUYING LONG  
RALLY - UP  
GOING UP  
HIGHER HIGHS  
HIGHER LOWS  
NORTH  
TRENDING UP DAY  
BULL



**BEAR MARKET**

When the selling market is more predominant than the buying market traders often refer the state of the market as:

SELLING  
SOUTH  
TRENDING DOWN DAY  
SHORT  
SELLING SHORT  
SHORTING THE MARKET  
DOWN  
GOING DOWN  
LOWER LOWS  
LOWER HIGHS  
BEAR  
BEARISH

**LAMB MARKET**

When the market you are looking at is not in a state of massive buying or selling, the market may be basically oscillating from one point to the another point and repeating the process.

This may happen for hours or even days. This is often referred to as a lamb market or a trading day. The language for this day might be.

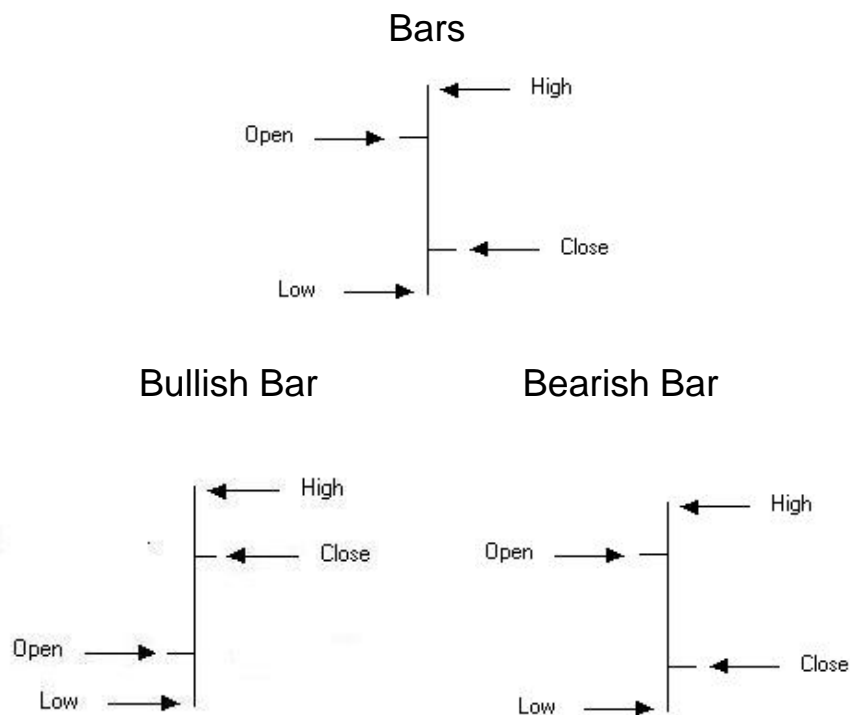
CONSOLIDATION  
ACCUMULATION  
NOISE  
BRACKETING  
ON THE FENCE  
LAMBS  
FLAT  
TRADING DAY

## Visual Trading

There are four main types of charts – Bar charts, Candlestick charts, Line charts and Point & Figure charts.

As I will only be using Bar charts and Candlestick charts in my analysis, I will introduce and explain these first.

## The Bar Chart

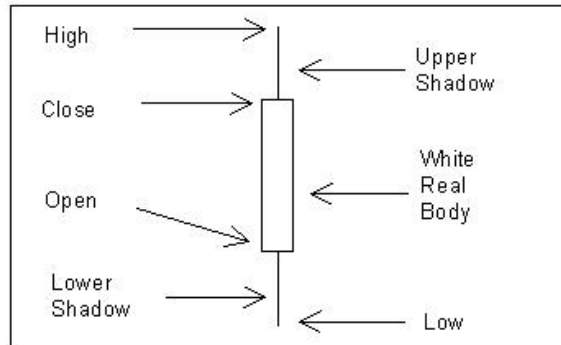


A bar represents one period of time. It is a means of measuring the duration of buying or selling within the market. The time intervals may be 5 minutes, 10 minutes, 30 minutes, 1 hour, 2 hours, 4 hours, 1 day, 1 week, even one minute if desired. You can use any time period you want.

## BAR CHART

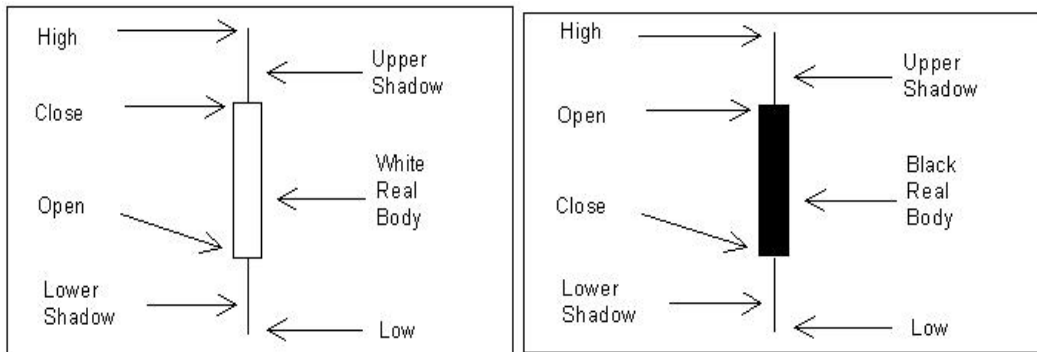


## Candlesticks Chart



Bullish Candle

Bearish Candle



The same thing applies to a candlestick chart as a bar chart. One period of time measures the duration of buying or selling within the market. The time intervals may be 5 minutes, 10 minutes, 30 minutes, 1 hour, 2 hours, 4 hours, 1 day, 1 week, even one minute if desired. Just like the bar chart you can use any time period you want.

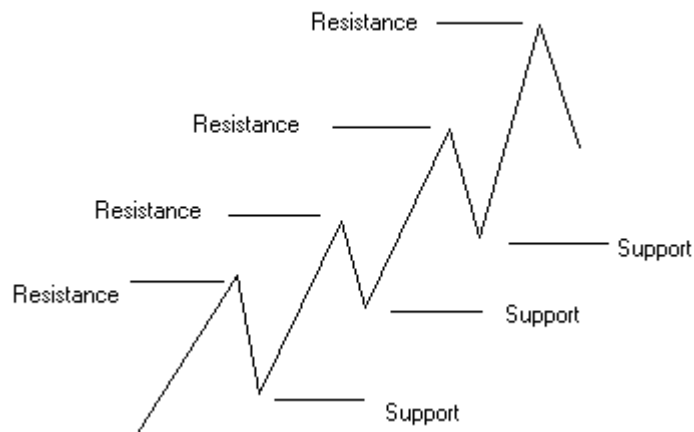
## Candlestick Chart



## Support And Resistance

Support and resistance is one of the most widely used concepts in trading. Strangely enough everyone seems to have there own idea on how you should measure support and resistance.

Let's just take a look at the basics first.



Look at the diagram above. As you can see this zig zag pattern is making it way up (bull market). When the market moves up and then pulls back, the highest point it reached before it pulled back is now resistance.

As the market continues up again, the lowest point it reached before it started back up is now support. In this way resistance and support are continually formed as the market oscillates over time. The reverse of course is true of the downtrend.

There are two interesting points I want you take note of.

1. When the market passes through resistance, that resistance now becomes support.
2. The more often price tests a level of resistance or support without breaking it the stronger the area is.



## Trend Lines

Trend lines are probably the most common form of technical analysis used today. I may also add they are probably one of the most underutilized as well.

If drawn correctly they can be as accurate as any other system or method you care to name. Unfortunately most traders don't draw them correctly or they try to make the line fit the market instead of the other way around.

In their most basic form, an uptrend line is drawn along the bottom of easily identifiable support areas (valleys). In a downtrend, the trend line is drawn along the top of easily identifiable resistance areas (peaks).



## Channels

If we take this trend line theory one step farther and draw a parallel line at the same angle of the uptrend or downtrend, we will have created a channel.

To create an up channel, simply draw a parallel line at the same angle as an uptrend line and then move that line to a position where it touches the most recent peak. This should be done at the same time you created the trend line.

To create a down channel, simply draw a parallel line at the same angle as a downtrend line and then move that line to a position where it touches the most recent valley. This should be done at the same time you created the trend line.





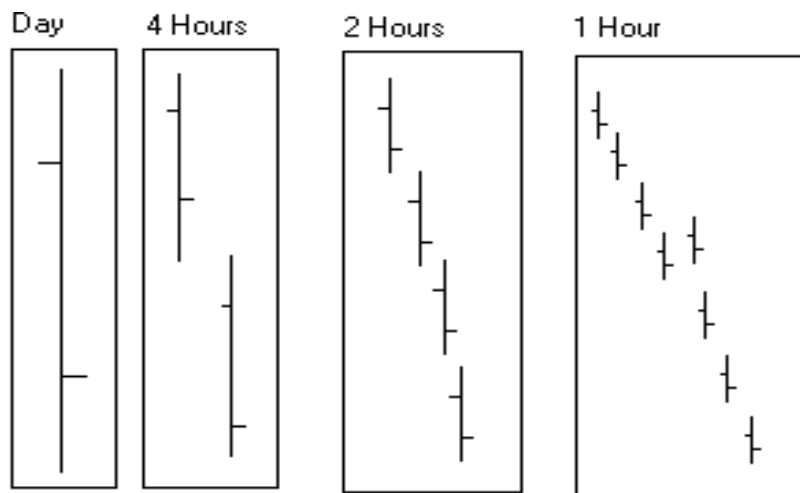
## Time Periods

Very important: Know where you live!

There is no correct time period to trade, only the time period you feel comfortable in.

If you ask someone to tell you where the trend is in the EUR/USD they would first have to find out what time period you were talking about. For a daily trader the trend may be up but for an hourly trader the trend may be down.

Lets discuss this a little further. Some of the charts we will be looking at are day charts; that is to say that, if you were looking at one bar – that one bar would encapsulates everything that happened during that day. It would have a high for the day, a low for the day, an open for the day and a close.



If you were looking at a chart made up of 4-hour bars, there would be twice as many bars. Each bar would have it's own open, high, low and close (OHLC). These may be different from the day OHLC bar as the bar is measuring all the price changes inside that particular time period, in this example, 4 - hours.

The same can be said for any other time period - whether it is 30 - minutes or 1 - minute e.g. it would take five 1-minute bars to make up one 5-minute bar.

N.B. We are talking about a standard market in the above example with 8 hours of operation. The FX market is 24 hours per day.

This is why it's impossible for someone to tell where the trend is in a particular security unless he knows what time period you are trading.

This is also why if you were looking at a daily bar and noted that the bar closed at e.g. 1.6500 it does not tell you what happened during the day.

If you were trading 5 - minute bars you might have watched it rise most of the day and made money only to see it close much lower later in the day.

It can be a good idea to trade longer time periods when you first start, as 5 - minute bars can often make new traders feel rushed when making decisions.

Also worth noting is that there is no one time period that makes more money than another. The reason you would trade a weekly bar as opposed to a 5-minute is purely a matter of choice and circumstance.

The only advantage you might have if you trade using smaller time frames is that you can utilize a better use of margin, as you can have your stops loss much closer to your entry point.

One of the secrets of trading is to trade in the time period you feel comfortable in. It is also a function of time and money.

## Paper Trading

What is paper trading? Paper trading is where you receive an imaginary amount of money e.g. \$50,000 and pretend to trade it as though it were real. Most brokers will set you up a demo (dummy) account where you can practice trading with all the benefits of a real account.

This serves two very important functions. The first is to let you get familiar with your brokers dealing station and how all the different orders are placed. Don't underestimate this. Whenever you learn a new piece of software there is a learning curve. You don't want to be on that learning curve with your own money.

Next, it will let you practice the method without risking any of your own money. You will feel a lot more confident about this or any other trading method if you have actually practiced trading with it and made money.

Let me just caution you on this. I always recommend that new traders spend at least three months paper trading before they even think about using real money but in all my years I have never actually seen anyone have the discipline to do it.

So why do they give up? Well, there are many reasons but most of all it is impatience. There is nothing more frustrating for a new trader than to have a paper trade on that is making money. All he can think about is how much money he is losing. It never occurs to the trader that this is actually an apprenticeship that needs to be served.

If you can't make money on paper there is no reason to think that you would make money with your own equity at risk.

There is a good argument that - no amount of paper trading will ever put you through the emotional turmoil a real trade will. This is true. There is no substitute for the emotional roller coaster your first few real trades will have on you. I can tell you this, the traders who spend more time paper trading in the beginning tend to handle the emotional situations better and make better traders.

At the end of the book you will find a link which will take you to brokers who can set you up with a free account to practice.

## Components Of The Method

Now we are starting to get to the meat of the course. Before I jump head long into how we are going to trade you need to first understand what makes the method work.

There are six main components to the method.

**Theory Of The Method**  
**Multiple Time Periods**  
**Trend With Moving Averages**  
**Trend Indicator**  
**Fibonacci**  
**Money Management**

## Theory Of the Method

My basic theory of trading the FX market is to identify a trend and once identified, stay with it for as long as possible.

I want to do this with the minimum risk but with the maximum potential gain.

For each trade I take I want there to be at least 2 to 3 times reward for the risk taken.

As a new trader you will inevitably want to try and enter the market too often, incorrectly identifying a trade. Just as a fisherman cannot guarantee he will catch a fish each time he goes fishing – neither can a trader guarantee he will find a trade each day he sits down in front of the computer screen.

One of the most important lessons I can teach you is patience. There will not be opportunities to trade every day and trying to think an opportunity into existence will only frustrate you.

I think a large part of why traders think they must trade every day is ingrained into them from when they worked for a living. People are so used to working 9-5 that they are totally uncomfortable with only working a few hours a day or not at all.

The other common fault I see new traders make is the incorrect placement of orders (stop loss, limit and entry orders). This is mainly because they are more worried about how much they are risking than if the stop is in the right place.

This also leads to frustrating as new traders continually enter position with a stop in the wrong place, which is taken only to find the market goes in the direction you first thought it would.

It is a common mistake of new traders to try and be over accurate. There is nothing wrong with trying to pin point the exact entry point but you must be realistic.

Your entry point, stop loss and exit price must all be logical. Not only must they be logical, but you must be able to reproduce the method you chose to decide those points on a consistent basis.

For me the most important point is market direction. Am I trading in the right direction?

If I know or am reasonably sure of which direction I am headed, I am not as concerned with how tight my stop loss should be. I would rather lose 60 pips with a well thought out entry point with good market direction, than loose 3 lots of 20 pips trying to achieve the same thing.

That is not to say that we can not have a tight stop, I just like the market to dictate where to put it.

## Multiple Time Frames

Early on in my trading career I used to trade off 5 – minute charts and that was it. Just one big 5 – minute chart and I could never understand why when everything looked good, the market would suddenly stall or reverse.

It never occurred to me to take a look at a large time frame to see what was happening. You see the larger the time frame the more important it is. Resistance and support are a lot more important on a weekly chart than they are on a 5 - minute chart.

When the market did stall on a 5 – minute chart, it was often because it had hit support or resistance on a larger time frame.

In all of our trades we will be using more than one time frame. Think of multiple time frames as different magnification of a map. When you look at a map to plan a long journey, you initially just want to know the broad strokes – am I headed in the right direction?

Because it is a fair distance between your departure point and your arrival point, you don't want to remember every street address along the way.

When you start the journey you make a mental note of the first big city or town and set off. As you are traveling all you are concerned about is that you are headed in the right direction. When you pass your first landmark of the big city, you then head for the next big city until you arrive at the city you intended to travel to.

Once you get to that city, you head for the suburb where your destination is. Once you get to the suburb you begin to look for details of the street address.

It is exactly the same with trading using multiple time frames. We start off with a broad idea of where we are headed and as we get closer we worry more about detail.

In the analogy of a trip, the city might be a 4 – hour chart, with the suburb being the 30 – minute chart and the street address being the 5 – minute chart.

I like to use three time frames. The largest time frame I consider my main trend, the next time frame down as my medium trend and the smallest time frame as the short-term trend.

You could use any combination of time frames you like as long as there is enough time difference between them to see a difference in their movement. It might be:

1 – minute, 5 – minute and 30 -minute

5 – minute, 30 – minute and 4 - hour

4 – hour, daily and weekly and so on.

What we have is a situation where the larger time frame let's you know what direction you should be headed and the next time frame, let's you know when you should enter the market. The last time frame can be used for entry or monitoring the position once entered.

For all of the examples, I will be using a 4 – hour, 30 – minute and a 5 – minute chart. Take a look at the image below to see what my screen usually looks like.



On the left is my 4 – hour chart, in the middle is my 30 – minute chart and on the right is my 5 – minute chart.

Looking at the examples, you will also notice that the charts look a bit congested (squashed). This is how I like my charts. I want to get a feel for the big picture and only really enlarge the chart once I am about to trade. I discovered that when I started trading I often had direction right but my entry was wrong. One of the reasons was that I was watching the market so closely, I lost perspective on where I was in the bigger picture.



## Trend Identification

There are literally hundreds of ways that you can use to identify a trend. It could be an indicator, moving average, support & resistance or just about anything else you want to name.

Not only are there hundreds of ways of identifying a trend, but the question is what trend are you talking about? Is it the daily trend, the weekly trend or the monthly trend?

I have my own way of identifying a trend, which I have found works well in the FX markets – so lets get started.

I use good old exponential moving averages (EMA) for my primary trend identification in combination with three different time frames.

The reason I use EMA's is that I have found no significant difference in using EMA's as opposed to simple moving averages, weighted moving averages or any other kind of moving average.

I also like big long moving averages as opposed to shorter time periods such as 5, 10 or 20 period moving averages. The reason I like the longer moving averages is that they are less inclined to whipsaw. Often with any combination of smaller moving averages you will find a lot of whipsaw.

For the three time frames we will use an 89 period EMA of the highs and an 89 period EMA of the lows.

This is our short-term trend. Our long-term trend will be 144 period EMA of the highs and a 144 period's EMA of the lows.

### Abbreviations

|       |   |
|-------|---|
| EMA   | = Exponential Moving Average  |
| 89's  | = The 89 period EMA of the highs and the 89 period EMA of the lows.   |
| 144's | = The 144 period EMA of the highs and the 144 period EMA of the lows. |



The reason I chose these periods is because they fit extremely well with this type of trading and also because they are fibonacci numbers.

I will cover fibonacci numbers later but the sequence goes like this

1,1,2,3,5,8,13,21,34,55,89,144 and on into infinity.

Of all the averages I tested, the 89 period and 144 period seemed to fit the FX market the best.

Have a look at the following 2 charts. They are both 4-hour charts.





The rules for the EMA bands are that when both of the shorter 89's cross above both 144's then the trend is up.

The trend remains up even if both 89's move into the 144's. It only changes to down if both 89's cross below the 144's at some stage.

The first chart of the AUD/USD has been in an uptrend for just over 40 days using the two sets of EMA bands.

The next chart of the USD/JPY has been in a downtrend for over 40 days and remains in a downtrend even though 89's have moved into the area of the 144's towards the right hand side of the chart.

The trend for JPY/USD will remain down until both 89's have crossed above the 144's.

In fact when I wrote this, all the majors were in a solid trend according to my criteria.

Nearly all charting services have EMA. When selecting the EMA from your charting service, you normally have the option of making the EMA of the close, high or low. In our method we only use the high and low not the close. I will mention more about the charting service I use in the recommended service section towards the end of the book.

## Trend Indicator

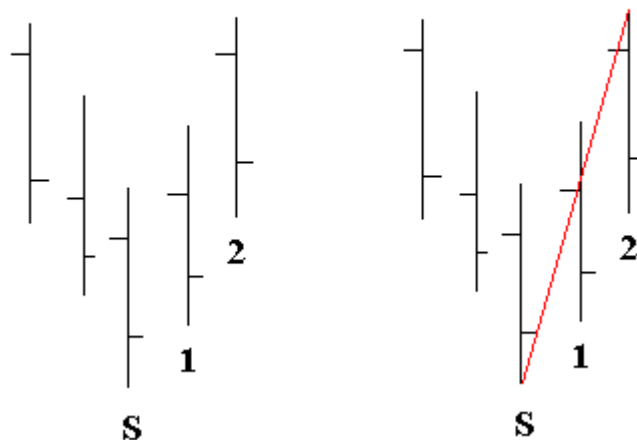
Because we use such big long moving averages, there will be lots of moves both up and down before there is a change in trend.

We need to identify these changes in direction to get the best possible entry. To identify these changes in direction we will use swing points. These swing points will lead to what we call the "Trend Indicator" (TI).

## Swing Points

A swing point "up" is when we have two higher highs than the "S" bar.

### Swing Up

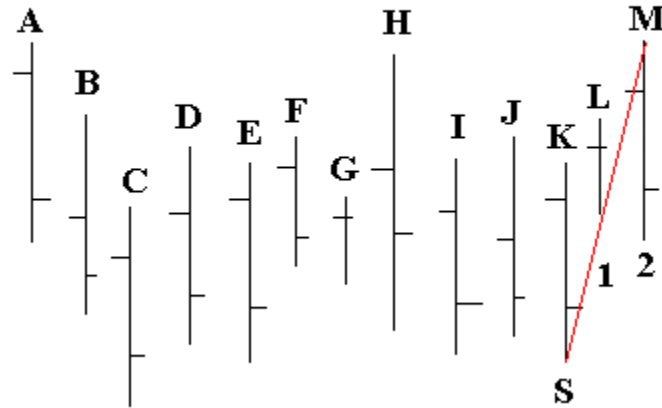


For the purpose of our swing points, we are not interested in the open or close of the bar. We are only interested in the high and low.

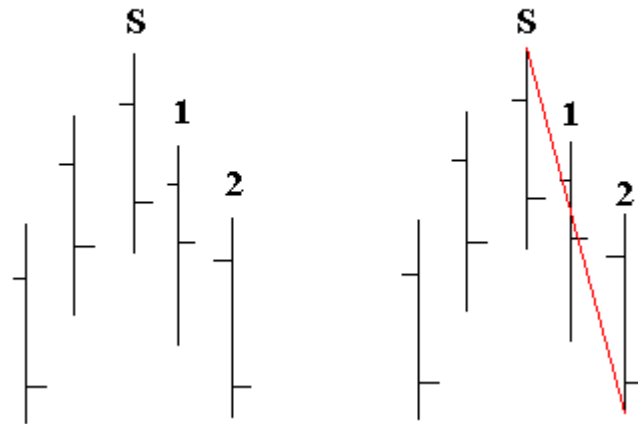
Take any bar on a chart and think of that as your starting point (S Bar). If you have two consecutive higher highs than the S bar then you have a swing up. If you don't have two higher highs then it is not a swing up and you do not mark it as an S bar.

Look at the diagram below. There are 13 bars but it was not until bar M that we actually had two consecutive higher highs than an S bar.

**Swing Up**



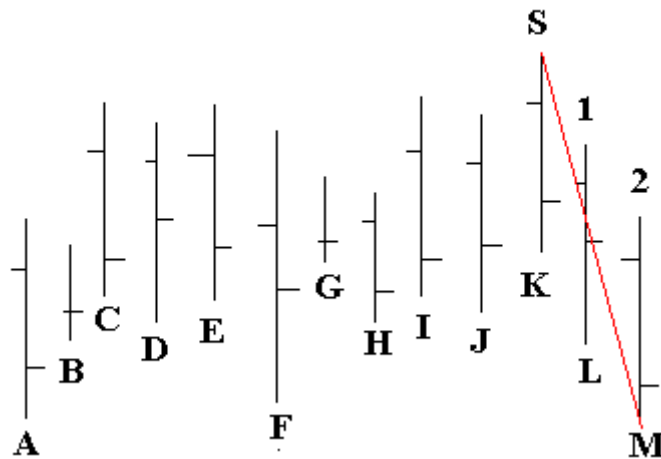
**Swing Down**



The reverse applies to the swing down. Use any starting point and name it the S bar. If you get two consecutive lower lows then you have a swing down. If you do not get two consecutive lower lows after the S bar then it is not a valid S bar.

You can see from the diagram below that although there are 13 bars but we did not get a confirmed swing down until bar M.

### Swing Down



### Trend Indicator Change

As you can see from the diagrams above, the swing points create peaks and valleys. In an uptrend there will be a succession of new higher peaks and higher valleys.

In a downtrend there will be a succession of lower valleys and lower peaks.

In an uptrend, the trend indicator can only change to down when the most recent valley (swing point) has been breached.

In a downtrend, the trend indicator can only change to up when the most recent peak (swing point) has been breached.



If we look at the next chart more closely you will get a better idea of the trend indicator.



This will become clearer as we go on. The most important point is to know where the swing points are. It is also important to know that when we talk about trend - I am referring to the 89's and 144's averages. The TI is something different. The trend (89's & 144's) can be up but the TI down and vice versa.

## Fibonacci

We will be using fibonacci ratios a lot in our trading so it's important you have a good grasp of how the studies work.

Fibonacci is a massive subject and there are a lot of different areas you could investigate. For the purposes of this method however, we shall only be concentrating on a few specific points.

### **First Some History Of Fibonacci**

Leonardo Fibonacci da Pisa was born around 1170, the son of a city official and merchant. He became a prominent mathematician and is credited with the discovery of what we now call the Fibonacci series.

After a trip to Egypt he published his now famous Liber Abacci (Book of Calculation) in which amongst other things he comes up with the sequence of numbers.

1,1,2,3,5,8,13,34,55,89,144>>On to infinity

If you add one of the numbers in the sequence to the number before it, you get the next number in the sequence e.g.  $3+5=8$  and so on.

After the first few numbers in the sequence, if you measure the ratio of any number to that of the next higher number you get .618 to 1 e.g. 34 divided by 55 equals 0.618. The further along the sequence you go the closer to phi you will get.

If you measure the ratio between alternative number you get .382 e.g. 34 divided by 89 = 0.382 and that's about as far into the explanation as I care to go.

As a trader you don't need to know any of this. Your charting program will work all this out for you. It just helps if you know the theory behind the indicator.

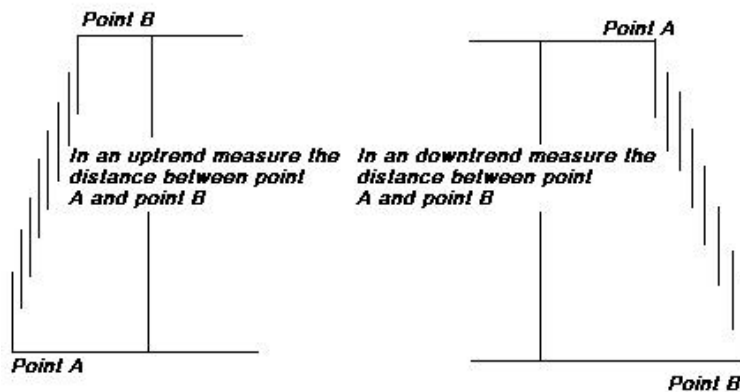
Now, although the three most popular fibonacci ratios for trading are .382, .500 and .618, we will only be using .382 (38.2%) and .618 (61.8%) for our retracement calculations.



I am often asked why I don't use the .500 (50%) retracement level and the reason is twofold.

1. I want to keep the method as simple as possible.
2. In the time frames we are dealing with, the 38.2% and 50% retracement are to close together to effectively place a stop.

In an uptrend, measure the distance between point A and point B and in a downtrend measure the distance between point A and point B. Where point A is always the lowest recent point in an uptrend and the highest recent point in a downtrend.



Look at the chart below of the EUR/USD. Point A is 1.1373 and point B is 1.1543. The total distance between the two points is 0.0170 pips.

If you worked out 38.2% and 61.8% of 0.0170 and subtracted it from point B (1.1543) you would get retracement levels of 1.1478 (38.2%) and 1.1438 (61.8%).





Also on the EUR/USD look at the chart below taking a measurement in the opposite direction.

Point A is 1.1855 and point B is 1.1717. The distance between both points is 0.0138. If you calculated the 38.2% retracement you would get 1.1770 and the 61.8% retracement would be 1.1802.



Now I don't want you to get too hung up on these measurements for two reasons.

1. Most charting software will work all these measurement out for you.
2. The probability calculator included in the course will also work these measurements out.

The idea of taking these measurements is to find an entry level and a place to put your stop. As you will see we will be using a 30 - minute (occasionally a 5 – minute) time frame for our entry and a 4 - hour to determine trend.

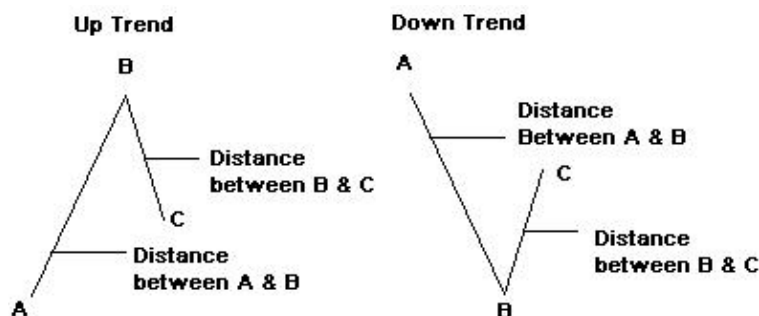
You will be entering on 38.2% retracement and placing our stop loss below the 61.8% retracement level.

## Targets

The next use of fibonacci you will be applying, is that of targets. Again the probability calculator will work everything out for you but it is important you understand how the calculator works.

You will always have three potential targets. Which target you select will depend on market condition and certain criteria.

Targets are calculated by measuring the distance between points A, B and C. Point C is the most recent low point of the retracement before the market moves up in an uptrend. In a downtrend the most recent high before the market continued down.



The calculations for targets are as follows.

**Target 1**

$$0.618 * (\text{Point B} - \text{Point A}) + \text{Point C}$$

**Target 2**

$$\text{Point B} - \text{Point A} + \text{Point C}$$

**Target 3**

$$1.618 * (\text{Point B} - \text{Point A}) + \text{Point C}$$

Lets Look at the chart of the EUR/USD again.



Point A was = 1.1373  
 Point B was = 1.1543  
 Point C was = 1.1443

Therefore

Target 1

$$0.618 * (1.1543 - 1.1373) + 1.1443 = 1.1548$$

Target 2

$$1.1543 - 1.1373 + 1.1443 = 1.1613$$

Target 3

$$1.618 * (1.1543 - 1.1373) + 1.1443 = 1.1718$$

On the next chart of the EUR/USD we use the same formula only in reverse.



Point A was = 1.1855

Point B was = 1.1717

Point C was = 1.1782

Therefore

Target 1

$$0.618*(1.1717 - 1.1855) + 1.1782 = 1.1697$$

Target 2

$$1.1717 - 1.1855 + 1.1782 = 1.1644$$

Target 3

$$1.618*(1.1717 - 1.1855) + 1.1782 = 1.1559$$

### **Money Management**

This is going to be one of the largest and most important sections of this book. Money management is often one of the most overlooked areas in trading.

All new traders want to do is jump in and get their feet wet. Ask a new trader to show you his trading log or trading plan and the majority of them won't be able to. This is where you can have the advantage.

Traders are not gamblers they are statisticians. You have to look at the markets like a scientist would. If you do X, will you get Y? You should measure and record everything.

Before you trade it is very important that you have some working knowledge of probability in order to maximize your trading technique.

Regardless of the method you use to trade FX you need to have good money management. It is the single most important part of your trading plan. Nothing works without it.

Before I get started on exact money management principles, I want to introduce you to some basic probability.

Every time you place a trade you are calculating your probability of success or failure. You wouldn't enter a trade if you didn't think you would make money. You make a decision the particular trade (event) has a high probability of success.

The question is how much of an edge do you have on that event?

If you have an edge then in theory you will eventually make money – or if you don't have an edge but the winning events far surpass the losing events, then you will make money.

Other factors have to be taken into consideration too, such as slippage and spread.

The first prize of course is to have an edge and for your wins to greatly surpass your losses.

The first point I want to make about your trading is this. Even if you have an edge you will at some time go through an aberrant run.

Let's say you have a method of trading with a 60% probability of success. Does this mean that for every 100 trades you will win 6 out of 10?

Not necessarily! You see wins tend to be skewed. They are skewed in two ways. First – there will tend to be only a few really big winners. That is to say if you made 500 pips you might find that you made 100 pips in one trade and 200 hundred in another trade and the rest where all made up of 30 or 50 pips.

The second way they are skewed is that you might find if you made a 100 trades and expected to win 60 of those trades - what 60 trades would you win?

The answer is that there is no way of knowing. How would you feel if the first 40 trades you made were all losses? Most traders would assume that the method or system didn't work and call it a day.

If you don't think that is possible - consider this. Imagine you have a coin and you wanted to try and predict how many times that coin would land on heads.

You decide to toss the coin in the air. It can only come down heads or tails. You know that these are the only two choices - or probabilities. If you toss the coin ten times, these are all the possible results:

10 heads and 0 tails  
9 heads and 1 tail  
8 heads and 2 tails  
7 heads and 3 tails  
6 heads and 4 tails  
5 heads and 5 tails  
4 heads and 6 tails  
3 heads and 7 tails  
2 heads and 8 tails  
1 head and 9 tails  
0 heads and 10 tails

Because the coin doesn't have a memory it doesn't remember that it landed e.g. 7 heads in a row or 7 tails in a row – so the chances are always 50/50. This is the law of independent trial.

The next time you have a beer with your buddy ask him what he thinks the odds are of tails coming up if you just tossed a coin in the air 10 time and every time it came down heads?

The point of this exercise is to make you think about probability. If you throw the coin in the air often enough it would eventually even out to 50/50. But if that where your trading account, would you still have enough money left in the account to see you through the bad runs?

Bad runs can and will happen to you at some stage and there is no way of knowing when.

### Dependent events

Trading is much more like blackjack (casino card game). If you start with for example 52 cards and the king of spades is dealt, what are the chances of that card coming out again on the same deck?

There is no chance. There are only 4 kings in each deck of cards. If you take out the king of spades there is zero probability of the king of spades coming up again in the same deck of cards, as there is only one, and it has just been taken out.

This is actually the basis of card counting. Card counting is the process whereby each card in the deck is assigned a value and the card counter counts that assigned value as it is dealt. When the count is in the counter's favor he will bet more heavily.

Through the process of counting cards a card counter can gain an advantage over the casino. This is why in certain countries a casino will ban a card counter once identified.

Blackjack obeys the laws of dependent events. If you have the mental capabilities you can beat blackjack. On the other hand because roulette obeys the laws of independent events you will never beat it. It is a mathematical impossibility to beat any game that obeys the law of independent trial (events).

So what's all this got to do with trading? Well, everything if you think about it. If you believe in the random walk theory you are getting very close to an independent event and if you believed in the Dow Theory then you would be close to dependent events.



## Trading and Probability

As a trader we are attempting to make only high probability trades. In other words we only want to trade when we believe the odds are in our favor.

One way we attempt to find opportunities in our favor is through technical analysis. This is what not to do. **Double up and throw up!**

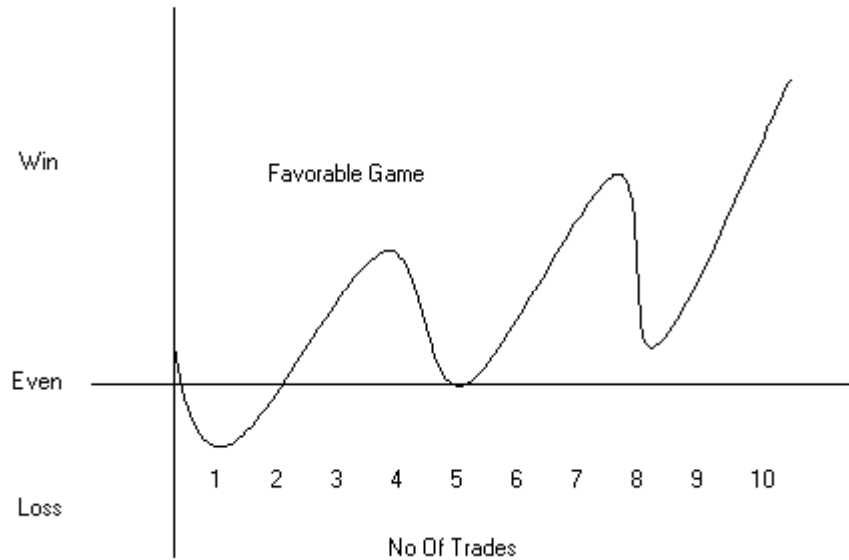
### Doubling Up After Each Loss

|               |           |
|---------------|-----------|
| First Trade   | \$100     |
| Second Trade  | \$200     |
| Third Trade   | \$400     |
| Fourth Trade  | \$800     |
| Fifth Trade   | \$1,600   |
| Sixth Trade   | \$3,200   |
| Seventh Trade | \$6,400   |
| Eighth Trade  | \$12,800  |
| Ninth Trade   | \$25,600  |
| Tenth Trade   | \$ 51,200 |
| Total Lost    | \$102,300 |

Well as you can see from the example above, if you doubled your position after each losing trade you would need a staggering \$102,300 in your account just to cover your losses.

You might ask how likely is that to happen? And that my friend was the point of the previous few pages. Just think back to the example with of the coins, an aberrant negative run can and **will happen**.

This is why I do not recommend doubling up after each loss. If you trade in a disciplined systematic manner, when your aberrant run does occur you will still be in the game at the end of the run.



| Ideal situation |         |           |            |
|-----------------|---------|-----------|------------|
| No Trades       | No Wins | No Losses | Total Wins |
| 2               | 1       | 1         | 1          |
| 4               | 3       | 1         | 1          |
| 6               | 4       | 2         | 4          |
| 8               | 6       | 2         | 6          |
| Total Trades    |         |           | 14         |

**In the above example we made 14 out of 20 winning trades or 70%**

| Actual    |         |           |            |
|-----------|---------|-----------|------------|
| No Trades | No Wins | No Losses | Total Wins |
| 2         | 0       | 2         | 0          |
| 4         | 4       | 0         | 4          |
| 6         | 6       | 0         | 6          |
| 8         | 4       | 4         | 4          |
| Total     |         |           | 14         |

As you can see from the above, the actual may be different from the theoretical even though we land up at the same place.

Probability is a huge subject all on its own and we could go on for ever explaining the ins and outs.

It is important to realize that regardless of the system or method of trading, there will be occasions when you have losses or even a string of losses.

When these occur it is important to have faith in your trading plan and not to try and double up to catch up.

Finally as you can see from the above examples, any trading system will go through times when it has more losses than wins.

This is where money management comes into play.

### Drawdown

Drawdown is a dirty word in trading but every trader will experience some drawdown. It is simply unavoidable.

Imagine that you start your trading account with \$10,000 and after a few trades you lose \$2,000. Your drawdown would be 20%.

Now lets say you make more trades and gain \$4,000 which brings you to \$12,000 ( $\$8,000 + \$4,000 = \$12,000$ ). After this, on the next trade you lose \$2000. Your draw down would be 16.7% ( $12,000 - \$2,000$ ). The \$12,000 was your equity peak - as that was the highest point in the period we looked at.

### Maximum Drawdown

Maximum drawdown is the lowest point your account reaches between peaks.

If you started your account with \$10,000 and the lowest amount you had in your account over a six-month period was \$5000 then you had a 50% drawdown.

You would need to make \$5,000 from the lowest point in order to get back to even. This is an important point because even though you lost 50% from your high of \$10,000 you would need to make 100% on the \$5,000 to get back to even.

### Measuring Drawdown Recovery

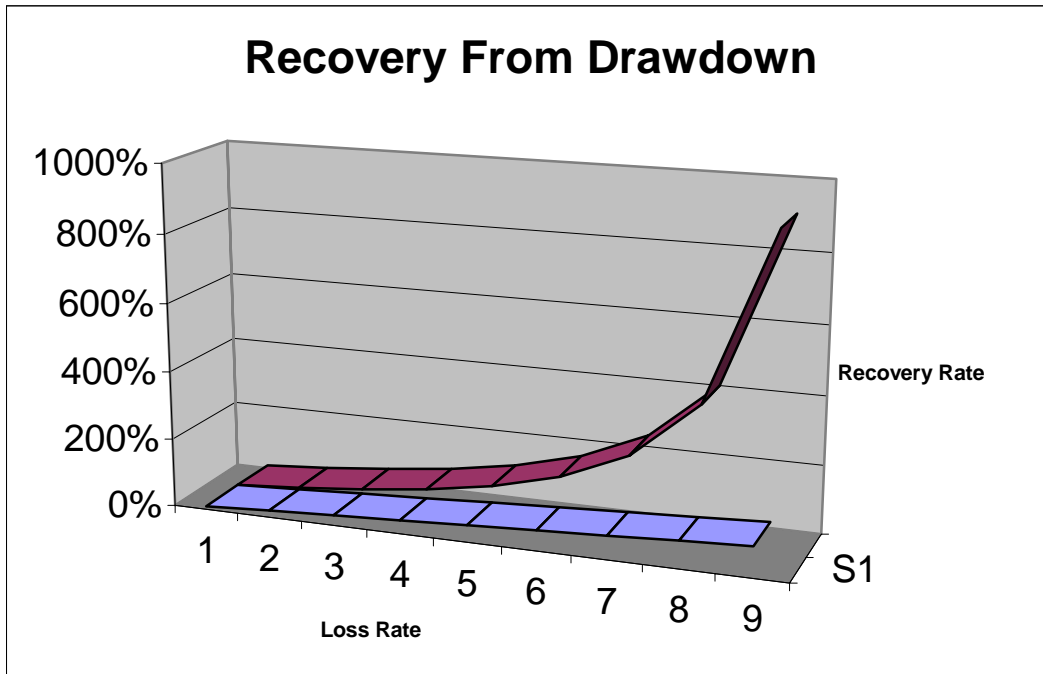
Drawdown recovery can confuse many traders. If a trader loses 20% of his account he thinks he needs to make 20% in order to get back to even.

This is in fact not true. If you started with \$10,000 and lost \$2,000 (20%) you would need to make 25% in order to get back to even. The difference between \$8,000 and \$10,000 is \$2,000. If you calculate the \$2,000 as a percentage of \$8,000 (not the original \$10,000) it works out to 25%.

| Loss Of Capital As A % | % Required To get Back to Break Even |
|------------------------|--------------------------------------|
| 10%                    | 11.11%                               |
| 20%                    | 25%                                  |
| 30%                    | 42.86%                               |
| 40%                    | 66.67%                               |
| 50%                    | 100%                                 |
| 60%                    | 150%                                 |
| 70%                    | 233%                                 |
| 80%                    | 400%                                 |
| 90%                    | 900%                                 |
| 100%                   | Blow Out/Broke                       |

You can clearly see what's happening here. As your drawdown increases the amount you need to make back increases faster.

I cannot emphasize this enough! You must be aware of risk. Understanding how basic probability and money management work is as important if not more important then any trading system.



This is the main reason I strongly advise new traders to use stop losses. If you use a stop then you will be able to define your risk.

If for example you decided to risk no more than 3% in any one trade, then the chances of going broke before your destroy your bankroll are minimal.

| Trade No# | Equity | 3% Of Equity | Equity | 20% Of Equity |
|-----------|--------|--------------|--------|---------------|
| 1         | 10,000 | 300          | 10,000 | 2,000         |
| 2         | 9,700  | 291          | 8,000  | 1,600         |
| 3         | 9,409  | 282          | 6,400  | 1,280         |
| 4         | 9,127  | 274          | 5,120  | 1,024         |
| 5         | 8,853  | 266          |        |               |
| 6         | 8,587  | 258          |        |               |
| 7         | 8,330  | 250          |        |               |
| 8         | 8,080  | 242          |        |               |
| 9         | 7,837  | 235          |        |               |
| 10        | 7,602  | 228          |        |               |
| 11        | 7,374  | 221          |        |               |
| 12        | 7,153  | 215          |        |               |
| 13        | 6,938  | 208          |        |               |
| 14        | 6,730  | 202          |        |               |
| 15        | 6,528  | 196          |        |               |
| 16        | 6,333  | 190          |        |               |
| 17        | 6,143  | 184          |        |               |
| 18        | 5,958  | 179          |        |               |
| 19        | 5,780  | 173          |        |               |
| 20        | 5,606  | 168          |        |               |
| 21        | 5,438  | 163          |        |               |
| 22        | 5,275  | 158          |        |               |
| 23        | 5,117  | 153          |        |               |

As you can see from the table above if you risked 20% on each trade and had 4 consecutive losses in a row, your drawdown would be almost 50%. If on the other hand you only risked 3% on each trade you would need 23 consecutive losses to get to the same 50% drawdown.

If you think 3% is not enough to risk on one trade consider this. I have never met a trader who has been in this game for any extended period of time that does not have some kind of stringent money management principals.

In fact the majority of traders who have been trading for a prolonged period would argue that 3% is too much. They would feel much more comfortable only risking 1%.

I also want you to note that if you are trading more than one pair or have more than one trade on at any given time, then the total amount you are at risk should be no more than 3%.

Let's say you are following three pairs and have one trade on in each market. You should add up the total amount that you are at risk for if all three trades lost.

For example if you had a starting account of \$10,000 and you had three trades on each with a \$300 stop loss then your risk is actually 9%. As each of your trades has the potential to lose \$300 the total amount at risk is \$900 which is 9% not 3%.

### Risk Reward Ratio

Risk reward ratio is simply the amount you risk as compared to the amount you expect to make.

If you have a stop in place which limits your risk to \$1000 but when your trade is successful you expect to make \$3000 then your risk to reward ratio is 3:1

| 10 Trades | Loss       | Win         |
|-----------|------------|-------------|
| 1         | \$1,000.00 |             |
| 2         |            | \$3,000.00  |
| 3         | \$1,000.00 |             |
| 4         |            | \$3,000.00  |
| 5         | \$1,000.00 |             |
| 6         |            | \$3,000.00  |
| 7         | \$1,000.00 |             |
| 8         |            | \$3,000.00  |
| 9         | \$1,000.00 |             |
| 10        |            | \$3,000.00  |
| Sub Total | \$5,000.00 | \$15,000.00 |

From the table above you can see that if you only selected trades where you thought you had a 3:1 risk reward ratio, then even if you were right only 50% of the time you would still make a profit.

## Risk Probability Calculator

By now you should have downloaded the “Risk Probability Calculator” (RPC). The RPC is just a guide to how much your potential gain or loss would be on any one trade.

I have found that if you stick to the rules using the RPC it will vastly improve your trading.

As you can see below on the excel sheet the first block is market:

**Chart Points.** These are the chart points we will market on our charts. They are Point A, Point B, and Point C.

From our earlier example of the EUR/USD we market points A & B as 1.1373 and 1.1543. Now as soon as you enter these two points the next block Retracement Levels will automatically complete.

Now here’s a little trick. You know where Point A is and you can see Point B but until the market pulls back to form Point C you don’t know where Point C is. Until such time as Point C has been formed you can use the 38.2% retracement level which has already been calculated.

This will give you some very good estimates until Point C has been formed.

The next block is marked **Targets.** These are our 3 potential target areas. This is also calculated automatically.

The last block **Potential Return.** This calculates if the trade is worth taking. Where you see **Trade/No Trade** - this automatically tells you if your reward is greater than 2-1. If your potential reward is greater than 2-1 then it will automatically read **Trade**. If the reward is less than 2-1 then it will automatically say **No Trade**.



Let's look at some examples.

**Risk Probability Calculator**

**Chart Points**

|         |        |
|---------|--------|
| Point A | 1.1794 |
| Point B | 1.2040 |
| Point C | 1.1935 |

You can use the .382 as an estimate until point C is confirmed

**Retracement Levels**

|       |        |
|-------|--------|
| 0.382 | 1.1946 |
| 0.618 | 1.1888 |

**Targets**

|          |        |
|----------|--------|
| Target 1 | 1.2087 |
| Target 2 | 1.2181 |
| Target 3 | 1.2333 |

**Potential Return**

|          | Risk   | Reward | Ratio | Trade/No Trade |
|----------|--------|--------|-------|----------------|
| Target 1 | 0.0058 | 0.0141 |       | 2.4 Trade      |
| Target 2 | 0.0058 | 0.0235 |       | 4.0 Trade      |
| Target 3 | 0.0058 | 0.0387 |       | 6.7 Trade      |

For new traders this can be a great help; but remember - just because you punched in some numbers does not make everything guaranteed.

The RPC is only an aid to help you make a decision. Let's look at how it can help.

If we only took trades that had the potential to be 2.6 times more profitable than our risk, then potentially you might have this scenario:

| Loss   | Win |
|--------|-----|
| 50     |     |
|        | 130 |
| 50     |     |
|        | 130 |
|        | 130 |
|        | 130 |
| 50     |     |
| 50     |     |
|        | 130 |
|        | 130 |
| 200    | 780 |
| Profit | 580 |

The hard part of course is the win column. You will always be able to define your loss with a stop loss but until you have the winner closed out, it can only be an estimate.

Also the RPC is set at 2-1. This means that each target will only show **Trade**, if you have the possibility of making twice as much money as you could lose.

This is one reason I prefer to take a slightly longer-term view of the market. Assuming the market has been in an uptrend for 20 days by our definition, then I prefer to stay in that trade for as many days as I can rather than sit down 20 days in a row and try and re-enter every day.

The plus side is that you will have fewer trades so will have less brokerage spread to pay and once you are in the trade it takes less time to monitor what's happening.

The down side is that if you are in a trade for more then 5 days you will have to hold the position over the weekend. This can be dangerous if there is any breaking news or sudden changes occurring over the weekend that could effect trading.

To prevent this, either close any open position on Friday and re-open them on Sunday night/ Monday, or only hold positions during the week.

This is why this method is so great. It is very adaptable. You can use it as a day trading or intraday trading method or as a position trading method or a combination of both.

## Trading Rules

### Long Trades

#### Rule #1

The 89's and the 144's on the 4 – hour chart and on the 30 – minute chart must both be in buy mode. By buy mode I mean that at some point the 89's have crossed over the 144's.

#### Rule #2

The TI (trend indicator) must be in buy mode. The TI must just be changing from down to up or already be in buy mode.

#### Rule #3

Once these conditions have been met then we use the 30 – minute chart for our entry, exit and target. The 5 - minute chart is used to monitor the position. It can also be used to enter the market once you gain more experience.

#### Rule #4

We only enter on a 38.2% retracement. You only place your stop loss under the 61.8% retracement and you only use the targets provided by the RPC.

#### Rule #5

You only select trades where the potential reward is at least twice the potential loss.

You will have to have patience. Even though there may be many trades that meet the above criteria – you still only select the very best trades as determined by market conditions.

## Short Trades

### Rule #1

The 89's and the 144's on the 4 – hour chart and on the 30 – minute chart must both be in sell mode. By sell mode I mean that at some point the 89's have crossed below the 144's.

### Rule #2

The TI (trend indicator) must be in sell mode. The TI must just be changing from up to down or already be in sell mode.

### Rule #3

Once these conditions have been met then we use the 30 – minute chart for our entry, exit and target. The 5 - minute chart is used to monitor the position. It can also be used to enter the market once you gain more experience.

### Rule #4

We only enter on a 38.2% retracement. You only place your stop loss under the 61.8% retracement and you only use the targets provided by the RPC.

### Rule #5

You only select trades where the potential reward is at least twice the potential loss.

You will have to have patience. Even though there may be many trades that meet the above criteria – you still only select the very best trades as determined by market conditions.

## EUR/USD Trade

This is an example of the method at work. The first chart is of the 4 - hour EUR/USD.

The main trend as determined by the 89's and 144's has been in buy mode for the last 40 days. In fact it has been in buy mode for much longer but the charts I use only show 40 days at a time.



The TI was previously in a downtrend and on the 26<sup>th</sup> November 03 it changed back to an uptrend. The TI does not need to move from down to up or vice versa before you can trade. It does however need to be in the same direction at the time you enter the trade.

You will find that you often get better trades if you wait for the TI to change. In other words if the main trend is up, determined by the 89's and 144's and the TI is down – at the point where the TI turns up is a good entry point.

As it happened the TI turned up, so you would then go to your 30-minute chart to look for an entry.

If you look at the next chart, which is the 30 - minute chart, the 89's and 144's were initially in sell mode.

Remember before you can trade both the 4 - hour and 30 -minutes charts, 89's and 144's must be in the same direction.

Once the 30 – minute 89's and 144's moved into buy, you were then looking for a low point (support) to use as Point A. This is where you start your fibonacci measurements.

I use low and high points, which are little areas of support and resistance. I don't use the swing points from the TI on the 30 – minute chart. It can happen that they are the same points, but it is not a prerequisite. For smaller time frames I prefer just to eyeball a low or high point.

When choosing point A, the more thrust (succession of higher highs and higher lows) there is the better.

As it happened as you can see from the chart below the market never pulled back far enough to give a 38.2% entry. Neither did the second line drawn. It wasn't until the third line that the market pulled back to the 38.2% retracement for an entry.



You will always know where Point A is because you choose that point. Point B you will find quickly because it is fairly easy to see when the market has made a high (resistance) and is pulling back.

So you have Point A marked and you mark what you think is B. With these two points you then need to make some decisions.

**You need to decide:**

- a) Am I going to take this trade?
- b) Where am I going to enter, exit and target?

Every trade you make is slightly different. Once you have been trading for a while you will get to know what a good set up looks like. To start with however you need some kind of help.

We have two points to work with – Point A and Point B. Point C hasn't been formed yet so you need to make an estimate of what your risk reward will be on the trade in order to make a decision.

What I do is enter the 38.2% retracement level into the RPC as an estimate of what Point C might be. Let's work through this.

**Risk Probability Calculator**

**Chart Points**

|         |        |
|---------|--------|
| Point A | 1.1794 |
| Point B | 1.2040 |
| Point C | 1.1946 |

You can use the .382 as an estimate until point C is confirmed

**Retracement Levels**

|       |        |
|-------|--------|
| 0.382 | 1.1946 |
| 0.618 | 1.1888 |

**Targets**

|          |        |
|----------|--------|
| Target 1 | 1.2098 |
| Target 2 | 1.2192 |
| Target 3 | 1.2344 |

**Potential Return**

|          | Risk   | Reward | Ratio | Trade/No Trade |
|----------|--------|--------|-------|----------------|
| Target 1 | 0.0058 | 0.0152 |       | 2.6 Trade      |
| Target 2 | 0.0058 | 0.0246 |       | 4.2 Trade      |
| Target 3 | 0.0058 | 0.0398 |       | 6.9 Trade      |

You can see under the heading “Chart Points” I have market Point C in RED. This is because I have used the figure from the “Retracement Levels” 0.382. I now have enough information to make a decision.

Our entry will always be the 38.2% retracement level and our stop loss will always be below the 61.8% so we just need to select a target.

I can see that all three targets T1, T2 and T3 all offer a good risk reward ratios and they are all marked as “Trade” in the Trade/No Trade column.

Because the market had pulled back to the 89’s on the 4 – hour chart you can expect support in that area. As support had already formed you could assume that the market was ready for a move back up.



This would lead me to think that a larger target was in order - either a T2 or T3. As T2 was going to be over 200 pips away and the T3 with the information we had was going to be close to 400 pips, the logical choice would be T2.

The reason T2 seems logical is that 200 pips is achievable in a day or two but it is unlikely to move 400 pips in such a short time.

With the entry, exit and target selected you can now place the trade. Using a buy entry order at the 38.2% retracement, a sell order below the 61.8% and a sell limit order at the target.

With all the orders in place you just need to wait and see how the trade develops.

What I am looking for at this point is how far back the market is going to come and if it comes back too far - has it taken my stop.

As the trade developed the market eventually pulled back to 1.1935. When marking Point C all you need to do is look for the lowest point (support) before the market starts back up again in an uptrend or starts back down again in a downtrend.

With Point C in place you can now go back to the RPC and enter 1.1935 into the Point C row. This also means you needed to adjust the limit order. The entry order will have been hit by this time and the stop loss order was still in place, so it is just the limit order that needed to be adjusted.

You now have this situation:

In the market at 1.1946  
Stop Loss Order at 1.1888  
Limit Order at 1.2181

The next chart is the actual trade. Point A was 1.1794, Point B was 1.2040 and point C was 1.1935. Even though point C was 1.1935 the actual entry was 1.1946 which was the 38.2% retracement from the A-B move. This happened on the 1<sup>st</sup> December 03.



The target was hit on the 8<sup>th</sup> December 03 for a profit of 235 pips.

The last chart is the 5 – minute chart. This remained in buy the whole time. I like to use the 5-minute chart for two reasons.

One – the 89's and 144's will change direction on this chart first so if you are in a long trade and the 5 – minute 89's both close below the 144's it might be time to close the trade. If you are going through a little congestion period, wait until you see a clear separation of the 89's and 144's before making a decision.

One or two bars that force a crossover are not serious on the 5 – minute chart but when you can see that averages are beginning to trend in the opposite direction that is a danger sign.

5 – Minute Chart of EUR/USD



The last thing I want to show you is the final RPC numbers, which you can see below. If you use this consistently it will help your trading especially in the beginning.

**Risk Probability Calculator**

**Chart Points**

|         |        |
|---------|--------|
| Point A | 1.1794 |
| Point B | 1.2040 |
| Point C | 1.1935 |

You can use the .382 as an estimate until point C is confirmed

**Retracement Levels**

|       |        |
|-------|--------|
| 0.382 | 1.1946 |
| 0.618 | 1.1888 |

**Targets**

|          |        |
|----------|--------|
| Target 1 | 1.2087 |
| Target 2 | 1.2181 |
| Target 3 | 1.2333 |

**Potential Return**

|          | Risk   | Reward | Ratio | Trade/No Trade |
|----------|--------|--------|-------|----------------|
| Target 1 | 0.0058 | 0.0141 |       | 2.4 Trade      |
| Target 2 | 0.0058 | 0.0235 |       | 4.0 Trade      |
| Target 3 | 0.0058 | 0.0387 |       | 6.7 Trade      |

## GBP/USD Trade

Let's move on to the next trade. The next few charts are of the GBP/USD.

As you can see on the 4 – hour chart below, the 89's and 144's are in buy mode and have been for some time. The TI changed from down to up on the 26<sup>th</sup> November 03 making a good entry point.



The next chart of the 30 – minute shows what happened next. I initially selected the low just before the TI change as my point A on the 30 – minute chart, but that point kept missing the entry of the 38.2% retracement.

Also because the market had retraced slightly and moved back up it seemed sensible to try a new Point A which was 1.7088. This eventually gave me a Point B of 1.7275.

Once I had these two points I knew my entry level was going to be the 38.2% retracement level of 1.7204.



Now for the interesting part of this trade. I followed the procedure outlined in the EUR trade and plugged in the numbers the same way. I used a proxy of the 38.2% retracement level as Point C.

Even before I plugged in the numbers I was thinking that I would use a T1. This is because it looked like the entry was a little late and the nearest target would seem to be the best option.

After the numbers were plugged in this is what the RPC looked like.

**Risk Probability Calculator**

**Chart Points**

|         |        |
|---------|--------|
| Point A | 1.7088 |
| Point B | 1.7275 |
| Point C | 1.7204 |

You can use the .382 as an estimate until point C is confirmed

**Retracement Levels**

|       |        |
|-------|--------|
| 0.382 | 1.7204 |
| 0.618 | 1.7159 |

**Targets**

|          |        |
|----------|--------|
| Target 1 | 1.7320 |
| Target 2 | 1.7391 |
| Target 3 | 1.7507 |

**Potential Return**

|          | Risk   | Reward | Ratio | Trade/No Trade |
|----------|--------|--------|-------|----------------|
| Target 1 | 0.0044 | 0.0116 |       | 2.6 Trade      |
| Target 2 | 0.0044 | 0.0187 |       | 4.2 Trade      |
| Target 3 | 0.0044 | 0.0303 |       | 6.9 Trade      |

You can see that the “**Trade/No Trade**” column had **Trade** besides all the targets. So far so good. The trade could then be set up with an entry for 1.7204, stop loss at 1.7159 and a T1 target of 1.7320.

The entry was hit 2<sup>nd</sup> December 03. Eventually Point C was formed at 1.7165.

That’s where a slight problem arose. A T1 target had been set but now that Point C had been formed the RPC looked like this.

**Risk Probability Calculator**

**Chart Points**

|         |        |
|---------|--------|
| Point A | 1.7088 |
| Point B | 1.7275 |
| Point C | 1.7165 |

You can use the .382 as an estimate until point C is confirmed

**Retracement Levels**

|       |        |
|-------|--------|
| 0.382 | 1.7204 |
| 0.618 | 1.7159 |

**Targets**

|          |        |
|----------|--------|
| Target 1 | 1.7281 |
| Target 2 | 1.7352 |
| Target 3 | 1.7468 |

**Potential Return**

|          | Risk   | Reward | Ratio | Trade/No Trade |
|----------|--------|--------|-------|----------------|
| Target 1 | 0.0044 | 0.0077 | 1.7   | Don't Trade    |
| Target 2 | 0.0044 | 0.0148 | 3.4   | Trade          |
| Target 3 | 0.0044 | 0.0264 | 6.0   | Trade          |

You can see that the “**Trade/No Trade**” with the real Point C was now showing **Don't Trade**.

This will happen at times and is precisely why I mention it. The dilemma is now that you are in the trade with a lower Point C, the RPC is telling you that it is no longer a viable trade for the target you selected. What should you do now?

When this happens you need to assess the situation. The stop loss level was 1.7159 (you would have had your stop under this level) and Point C was 1.7165. It would have been pointless to close the position for the sake of a few pips. The better decision is to wait and see how it plays out.

If the market starts making its way up you can follow it closely and as soon as it looks like it might not make any further progress close the position.

As it happened the market made a fairly strong rally and hit T1 the same day for a profit of 77 pips.



## USD/JPY Trade

The USD/JPY trade is a good example of a nice simple trade. The TI changed to down on the 1<sup>st</sup> December. I wasn't initially all that excited about the trade as the 89's had moved into the 144's area and was causing congestion on the 4 – hour chart.

But as the TI broke I started paying attention to the 30 – minute chart.



When the 30 – minute started breaking down it had all the looks of a solid break. This will come with experience. You will develop a sense for when a break is real or false. Using the rules will help you stay out of trouble.

The obvious Point A would be the high point just before the break of the TI on the 30 – minute chart. The problem is that as the moved developed you would have missed the entry, as the market never pulled back enough for a 38.2% retracement.

You can see on the 30 – minute chart below that minor support and resistance formed and eventually the support gave way.



This is telling you that if you want on board you need to rethink Point A. That little resistance area is also a good point to mark as Point A, which is exactly what happened.

Point A now became 108.79 and Point B became 108.07. This gave you a 38.2% retracement level of 108.35 which was hit on the 3<sup>rd</sup> December 03.



Now all you have to do is select a target. You would of course follow the procedure of the first two trades.

As you can see from the 4-hour chart the JPY had been in consolidation for some time and was due to make a break.

By the look of the 30 - minute chart it looked like this might be it and I would select a T3 without question. Point C eventually formed at 108.48 to give a T3 target of 107.32

There was a valley of support around the 107.50 level on the 4 – hour chart, which was close to our T3 target of 107.32. This support level could have halted the move but you can monitor the progress as the trade develops.

## 5 Minute Chart



The 5-minute also stayed in sell mode through the move. As I mentioned earlier, I like to keep a close eye on the 5 minute as the trade progresses.

As it happened there was nothing to worry about. It did stall a little around 107.50 level but as it wasn't making any progress up. You therefore could feel reasonably comfortable that it would reach T3. This happened on the 8<sup>th</sup> December 03.

The risk reward ratio on this particular trade was excellent. You were only risking 17 pips to make 103 pips – over a 6-1 ratio. Total profits 103 pips.

This is what the RPC looked liked this

**Risk Probability Calculator**

**Chart Points**

|         |        |
|---------|--------|
| Point A | 108.79 |
| Point B | 108.07 |
| Point C | 108.48 |

You can use the .382 as an estimate until point C is confirmed

**Retracement Levels**

|       |        |
|-------|--------|
| 0.382 | 108.35 |
| 0.618 | 108.51 |

**Targets**

|          |        |
|----------|--------|
| Target 1 | 108.04 |
| Target 2 | 107.76 |
| Target 3 | 107.32 |

**Potential Return**

|          | Risk  | Reward | Ratio | Trade/No Trade |
|----------|-------|--------|-------|----------------|
| Target 1 | -0.17 | -0.31  | 1.8   | Don't Trade    |
| Target 2 | -0.17 | -0.59  | 3.4   | Trade          |
| Target 3 | -0.17 | -1.03  | 6.1   | Trade          |

OK, you should be starting to get the hang of it by now. I will give you one more example just to make sure.

## AUD/USD Trade

The AUD/USD is an unusual pair, as it tends to drift rather than trend strongly, particularly on small time frames.

On 26<sup>th</sup> November 03 the TI changed from down to up. This of course will make you pay attention to what's happening on the smaller time frames.



By switching to the 30 – minute chart you could see things more clearly. It didn't actually look that interesting until the 1<sup>st</sup>/2<sup>nd</sup> December when the 89's and 144's started to separate. That's when you would have been starting to look for an entry.

I marked Point A as 0.7213 and Point B as 0.7295 this gave me a 38.2% retracement level of 0.7264, which was, hit on 2<sup>nd</sup> December 03. Point C was marked at 0.7262 after the market began to make its way up.

I followed the same procedure of the other trades of course before I imputed Point C.



I selected T2 (target 2), because I knew by now that the dollar was weakening across the board and I expected the AUD/USD to gain. I almost always go for a T1 or T2 with the AUD/USD.

T2 was hit on 3<sup>rd</sup> December for an 80-pip gain. You can see the numbers of the RPC below.

**Risk Probability Calculator**

**Chart Points**

|         |        |
|---------|--------|
| Point A | 0.7213 |
| Point B | 0.7295 |
| Point C | 0.7262 |

You can use the .382 as an estimate until point C is confirmed

**Retracement Levels**

|       |        |
|-------|--------|
| 0.382 | 0.7264 |
| 0.618 | 0.7244 |

**Targets**

|          |        |
|----------|--------|
| Target 1 | 0.7313 |
| Target 2 | 0.7344 |
| Target 3 | 0.7395 |

**Potential Return**

|          | Risk   | Reward | Ratio | Trade/No Trade |
|----------|--------|--------|-------|----------------|
| Target 1 | 0.0019 | 0.0049 |       | 2.5 Trade      |
| Target 2 | 0.0019 | 0.0080 |       | 4.2 Trade      |
| Target 3 | 0.0019 | 0.0131 |       | 6.8 Trade      |

I don't get scared out of an AUD/USD position easily. I know from experience that when it gets direction it can stay headed that way for a long time.

OK, let's just recap on those four trades. We made 495 pips in 8 days of trading.

- EUR/USD – 235 pips
- GBP/USD – 77 pips
- USD/JPY – 103 pips
- AUD/USD – 80 pips

Now as you might expect I have only shown winning trades here. There will be times when you lose. It is just part of the game. You can not trade without loss.

Also it's important to get a feel for the market. When the dollar weakens it generally weakens across the board just as when it strengthens.

I have not shown any USD/CHF trades, as I never trade both the EUR/USD and USD/CHF at the same time. There is a strong correlation between the currencies but particularly between the EUR and CHF. If you trade both at the same time there is a strong possibility that if you lose one trade you will also lose the other.

Optimists will argue that you could win both trades, I just like to either trade the EUR or the CHF. You will probably develop a preference for one of them.

When you start trading I would suggest you trade one pair until you feel comfortable and gradually increase to 4. Believe me trading 4 pairs at a time can be a handful. I wouldn't go beyond that unless you intend to position trade. With position trading you only need to check on the pairs once a day.



## Advanced Techniques

In this section I am going to cover a slightly different technique for entering the market by using of a different set of indicators. Keep the 89's and 144's on the charts as this is still the main trend identifier.

You can combine this technique with the method we have just covered or you can use it as a stand-alone method.

For this particular method you will use three indicators. All the indicators are readily available on most charting services so I will discuss them only briefly.

### **Moving Average Convergence-Divergence**

Moving Average Convergence-Divergence (MACD) was originally constructed by Gerald Appel an analyst in New York. Designed for analysis of stock trends, it is now widely used in many markets.

MACD is constructed by making an average of the difference between two moving averages. The difference of the original two moving averages and the moving average of the difference can be plotted as two lines, one fast and one slow.

The setting we will use are 12 – 26 – 9

### **Williams % R**

Williams % R was developed by Larry Williams and is sometimes know as the upside down indicator because as the readings go up the numbers go down.

When you see a reading show negative e.g. -20 simply ignore the minus sign. You therefore get a situation where below 80 is oversold and above 20 (-20) is overbought.

We set the Williams % R at 89 on set up.



## Relative Strength Index

Relative Strength Index (RSI) was developed by J.Welles Wilder Jr. and introduced in his book '*New Concepts In Technical Trading Systems*'. It is one of the most popular technical tools around.

Relative strength Index (RSI) is measured on a scale from 0 -100 with a reading above 70 being overbought and a reading below 30 being oversold. Originally he recommended a 14 period as the setting but I prefer 13.

RSI set at 13 on set up

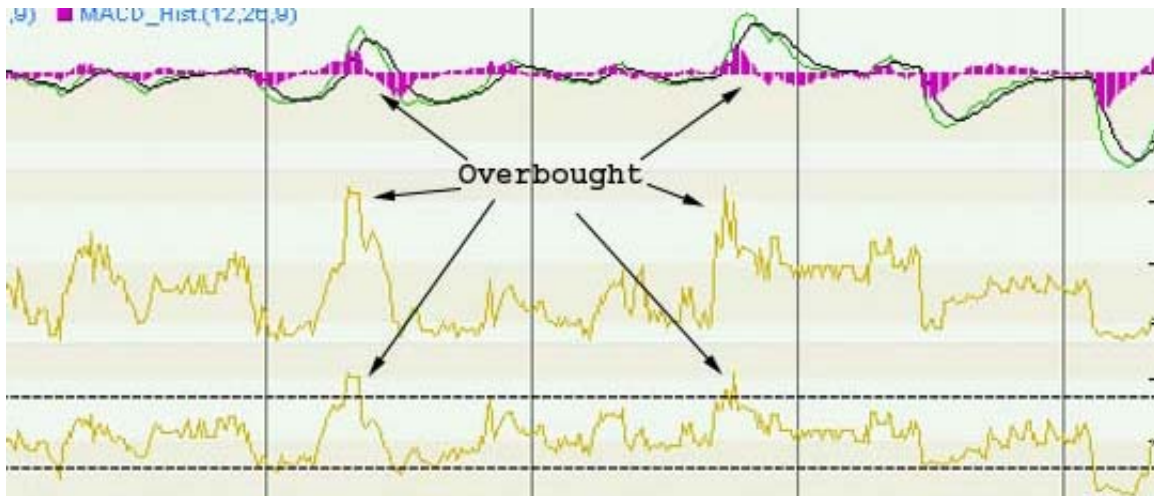
What am I trying to achieve with these indicators?

I am using the indicators as overbought and oversold indicators. Not only that, I want them to be at the absolute maximum of their overbought or oversold range.

Because you want them at the maximum of their range, signals will be less but more reliable. Also, although I have mentioned at which level these indicators become overbought or oversold I want you to forget these levels and just concentrate on what you see. e.g. look at a minimum of 10 days on a 30 – minute chart and just identify the extreme areas.

The reason I prefer to compare extreme areas on a chart as opposed to set levels, is that market conditions are always changing. What was extreme in the last 10 days may not be extreme in the next 10 days.

Let's take a look at some overbought and over sold conditions



As you can see from the chart above, you don't need to be a rocket scientist to see where the indicators, regardless of their name or reading are at extreme points.

It is these extreme points that we are interested in trading. I don't want you to get too hung up on the exact point at which something becomes overbought or oversold. Look at it in the context of the last 10 days or so for small time frames such as 5, and 30 minutes charts.

The next chart is of oversold conditions.



**Now even though on both charts there is clearly overbought and oversold conditions. The trick is to only trade short when overbought in a downtrend and only trade long when oversold in an uptrend.** The 89's and 144's must both be in the same condition (buy or sell) on both the 4 – hour and 30 - minute charts.

This might seem a bit strange to some of you, as the point at which it becomes overbought or oversold is actually the point at which the market is building momentum.

By the time the indicators are at extreme levels it is already too late to enter in that direction. Think of it as a rubber band that has been stretched to breaking point. Once you let go it will bounce back to its original shape.

The reason this technique is so successful is because you are actually trading against the crowd.

In the first example of overbought on the last page, which is actually a chart of the USD/JPY 30 – minute chart. Both the 4 – hour and 30 - minute 89's and 144's were in sell mode. Because of this you are only interested in selling opportunities.

The example of the oversold chart is actually the EUR/USD. On both the 4 –hour and 30 – minute charts the 89's and 144's are in buy mode. You are therefore only interested in buying opportunities.

As you can also see from both charts you want all three indicators (MACD, %R, RSI) to be overbought or over sold at the same area. Notice, I did **not** say at exactly the same time, as you may find that %R and RSI reach overbought and oversold before the MACD does with these settings.

Ideally %R and RSI will be at an extreme reading first, shortly followed by MACD. %R and RSI will then start to change direction and for there to be a signal with the MACD.

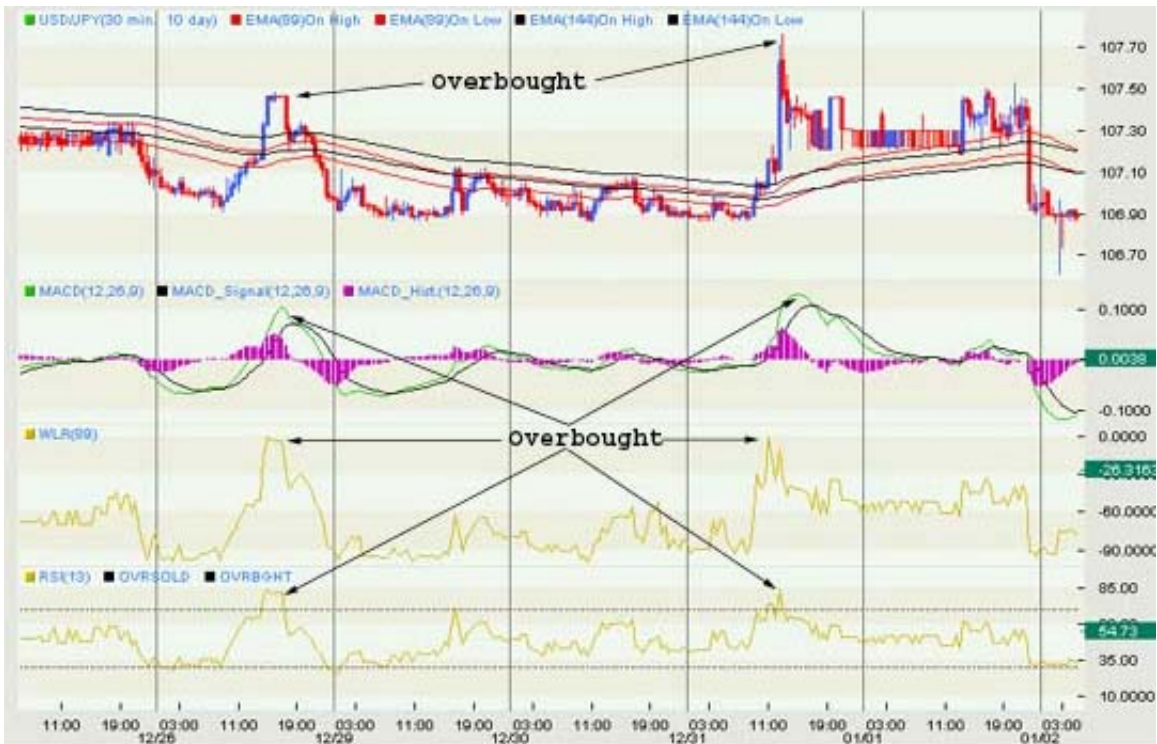
Let's have a look at a few examples of how we can actually trade this.

## USD/JPY

The first trade is of the USD/JPY. The 4 – hours 89's and 144's are in sell mode, as are the 30 – minutes.

The first chart shows some perspective of where overbought and oversold actually are. The chart is a 30 – minute chart and you can clearly see that there are two high points in both price and in all three indicators.

Because you are in sell mode according to our trend (4 – hour & 30 – minute charts) these peaks are a great time to sell the market.



The next chart is the same chart, zoomed in on the most recent peak.



At 11h00 the Williams % R reading was 0, at 12h30 the RSI reading was 84.23 and at 15h00 the MACD was 0.13091.

As I have mentioned earlier I am not too concerned with the actual reading or the exact time these reading happened. What I am concerned about is that the three indicators all reach extremely overbought levels in close proximity to one another.

I also want the indicators to be at an extreme point relative to the last 10 days or so. This tells me that the market is set up to at least pull back and is likely to reverse and continue the downtrend.

The next course of action is to drop down to the 5 – minute chart and look for an entry.



The next chart is what the 5 – minute looked like during this time period. You will notice that the 89's and 144's are actually in buy mode during this time. This is quite common when the market is extremely overbought in a downtrend. As the trade begins to work the averages will get back in line.



The next chart shows the actual trade. The market began to consolidate forming support at 107.17 and resistance at 107.53.

I like to use fibonacci to enter the market regardless of the trade but there are times, particularly in extreme conditions when it is more suitable to use a little breakout trade.

By breakout trade I mean that if I want to get long I look for a level of resistance and when it breaks that level it is a breakout. The opposite true for short trades.



As there was support at 107.17, an entry order would be placed just under there to take you short if the market breaks down. The stop loss would be placed above resistance at 107.53. That only leaves a target to aim for. As the risk on this trade was 36 pips (107.53-107.17) then you would select at least twice the reward as a target, which would be 72 pips. If you take 72 pips from the entry level of 107.17 you get a target of 106.45.

The target was easily hit a few days later. You will find with these types of trades, that when the market does break down or up as the case may be it can be explosive.

## GBP/USD

The next example is of the GBP/USD. The first chart is the 30 – minute. Both the 4 – hour and 30 – minute charts 89,s and 144's were in buy mode at the time of the trade.



In this particular trade the RSI maxed out first at 21h00 with a reading of 29.15. Next was %R, which came in at 88.89 at 22h00 and MACD was – 0.0015 at 23h00.

Again I mention that I am only looking for these indicators to reach extreme levels in proximity to each other. They do not have to be oversold or overbought at exactly the same time. Every now and then though, you do get all three hit an extreme level at the exact same time, but it is the exception rather than the rule.



The next chart is the 5 – minute of the trade during the same time. I have taken off the 89's and 144's to make this clearer.



The actual trade is what I call a belt and braces trade. The reason I call it this is because in situations like this I know I want in and I will place more than one entry order.



The market bottomed at 1.7787 to give point A. Then the price moved up to point B at 1.7823 and formed minor resistance. Once the market started to pull back I placed two entry orders. One just above resistance, at point B (1.7823) and one at the 38.2% retracement of 1.7809.

Until point C was formed, a stop would have been placed under point A of 1.7787, as the stop was also acting as a stop for the breakout trade.

The reason I have two entry orders placed is that as I mentioned earlier, these trades can move fast and the market does not always pull back for a Fibonacci entry. By placing a breakout and fibonacci entry I am more assured of a trade.

If the market does pull back to the fib level then I have the choice of either canceling the breakout trade or leaving that trade on and going for a double entry with two positions.

As it happened the market came back nicely to 1.7804 which took me into the market on the fib trade.

The last thing that needed to be done was select a target. This is easy in a trade like this. If you use the breakout entry just select twice your risk and if you use a fib entry stick to the normal plan. Because I used a fib entry I selected a T3 which gave a target of 1.7862 which was hit easily for a profit of 53 pips.

For this type of trade you will often use a T2 or T3 as a target as these levels are often strong continuation levels.

## USD/CHF

This last trade is the USD/CHF. The first chart is a 30 – minute chart. There are some interesting things about this trade. I have also included the channel lines as these can really help put thing in perspective.

If you look at the chart you will see that %R at 22h00 was reading – 2.19, RSI at 22h30 was 77.01 and MACD was 0.00242. This all happened in the vicinity of point A on the chart.

As you can see MACD and RSI started to turn down as expected but then the market continued up to make a slightly higher high at point B. This is called bearish divergence. This happens when an indicator turns down but the market makes a new high. The opposite is true for bullish divergence.

Anyway, this can be a very strong indication that the market is in an exhaust move. Meaning it is making a last ditch attempt at a move up.



The next chart is what it looked like on the 5 – minute. Initially it looked like a fairly straight - forward fib trade. You can a nice peak between 22h00 – 23h00 and the market started down as expected.

Remember at this time you don't know there is going to be divergence so you would have acted on the information you had and went for a fib trade.

Point A was the peak at 1.2480. Point B formed at 1.2449 and Point C formed at 1.2465. The three target were

- T1 = 1.2446
- T2 = 1.2434
- T3 = 1.2415

I immediately chose a T3 as this move was most likely a reversal. The move progressed down nicely and formed S1 (support). No

problems so far, although I like to see a slight drifting move rather than a strong pullback.

Anyway, the market pulled back to R1 (resistance) and still no problem. The problem comes in at S2, which bottomed out a 1.2434 our T2 target.

If you were going to make it to T3 on this move the market should have pushed through S1 or had a slight pullback and then push through. As the market started to rally fairly strongly from S2 I would have moved my stop to the entry level of 1.2461, which was also just above R1



As you can see from the next chart this would have been a wise move as the market did come back strongly. Even if you never moved your stop you would have only risked around 10-15 pips.

So I will assume you have been taken out of the trade either at break even or a small loss. This is the point that separates the boys from the men. Most traders at this stage will not know what to do next or assume that the market is going up - but remember our indicators by

now are showing bearish divergence on the 30 – minute chart which, in fact makes for an even stronger trade.



The 5 – minute chart above is the second trade. The market made a new higher high at 1.2484 causing divergence on the 30 – minute chart and presenting us with a great opportunity.

I have drawn the trend lines from the 30 - minute chart points. These can be very good confirmation lines when entering a trade.

You already had a good support level at 1.2437, which would act as our trigger for entry. If the market broke through this level then you would automatically be taken short. It would also break the steeper trend line at approximately the same point, which would further strengthen the view the market was breaking down.

Because you already tried a fib entry and failed and because the chart now had easily identifiable support and resistance levels a breakout trade was a better choice for entry.



The entry order was placed just under 1.2437 to take us short on the breakout. The entry was hit and a stop loss was placed above resistance at 1.2484. This gave a total risk of 47 pips - therefore the minimum target was 1.2343, which was easily hit for a profit of 94 pips.

The reason I showed the first trade in the USD/CHF was to demonstrate that not every trade will be a winner. The question is not will every trade be a winner but rather did I make a good trade? The fact that the first trade did not work out is irrelevant, as all you need to do is make enough trades with this particular set up to be successful.

### **Things To Consider**

Before you can master any system or method you must have some kind of mastery of self.

If you don't have control of your emotions, then you will have no control over your trading.

You will come to realize that trading is a business just like any other. It may be fun and more interesting than most businesses but it is still a business.

You would never consider betting your business on one throw of the dice, yet many traders lose control and trade like mad men.

Take your time – the markets will be there next year and the year after. Get used to the method first by paper trading (using imaginary money) first. You will find a list of brokers who will give you a free account to practice with in the next section.

Only once you have paper traded for some time and are showing a profit should you even consider using real money.

If you find yourself wanting to jump in at the deep end before you have fully tried and tested the method then you need to ask yourself if you are really in control of yourself.

Trading can give you whatever you want, but just like everything else in life there is a price to be paid. That price is your ability to think like a machine and be unaffected by the inevitable ups and downs.

### **Traders Resource**

The trader's resource is meant as a one - stop place where you can find the latest information in the forex world. You can see it [here](#) or you can copy and paste this URL

<http://www.surefire-forex-trading.com/res.html>

The charting system used in this ebook and the brokers I recommend will all be found at the link above or you can just click [HERE](#).

I truly wish you all the success in the world. Nothing would make me happier than if you drop me a line and share with me your success stories.

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God Bless and good trading

Mark McRae



